PART
One
Questions
Questions on Each Chapter

CHAPTER 1: THE ADVERSARIAL NATURE OF FINANCIAL REPORTING

1. Three ways that corporations can use financial reporting to enhance their value are:
   a. 
   b. 
   c. 

2. The true purpose of financial reporting is _________.

3. Corporations routinely ________ because the appearance of ________ receives a higher ________ multiple.

4. According to the ________, reversals of the excess write-offs offer an artificial means of ________ in subsequent periods.

5. The following are some of the powerful limitations to continued growth faced by companies:
   a. 
   b. 
   c. 

6. Some of the commonly heard rationalizations for declining growth are:
   a. 
   b. 
   c. 

7. ________ reached its zenith of popularity during the ________ movement of the 1960s. However, by the 1980s, the stock market had converted the ________ into a ________.

8. ________ is one of the ways that the notion of diversification as a means of maintaining ________ is revived from time to time.
9. The surprise element in Manville Corporation’s 1982 bankruptcy was, in part, a function of ____________.

10. The analyst’s heightened awareness of legal risks are a result of bankruptcies associated with:
   a. ______________________________________________________________________
   b. ______________________________________________________________________
   c. ______________________________________________________________________

11. Some of the stories used to sell stocks to individual investors are:
   a. ______________________________________________________________________
   b. A “play” in some current economic trend such as
      i. _____________________________________________________________________
      ii. ___________________________________________________________________
   c. ______________________________________________________________________

12. When the story used to sell stocks to individual investors originates among stockbrokers or even ____________, the zeal with which the story is disseminated may depend more on ____________ than the ____________.

13. The ostensible purpose of financial reporting is ____________ of a corporation’s earnings.

14. Over a two-year period BGT paid L&H $35 million to develop translation software. L&H then bought BGT and the translation product along with it. The net effect was that instead ____________, L&H recognized ____________.

CHAPTER 2: THE BALANCE SHEET

1. A study conducted on behalf of Big Five accounting firm Arthur Andersen showed that between ____________ and ____________, book value fell from ____________, percent to ____________, percent of the stock market value of public companies in the United States.

2. As noted by Baruch Lev of New York University, two examples of how traditional accounting systems are at a loss to capture most of what is going on today are:
   a. ______________________________________________________________________
   b. ______________________________________________________________________
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3. In the examples in Question 2 there is no accounting event because ____________.

4. Some of the distinct approaches that have evolved for assessing real property are:
   a. ____________
   b. ____________
   c. ____________

5. Some financial assets are unaffected by the difficulties of evaluating physical assets because ____________ in ____________ markets.

6. Under the compromise embodied in SFAS 115, financial instruments are valued according to ____________ by the company ____________.

7. If a company wrote off a billion dollars worth of goodwill, its ratio of assets to liabilities would ____________. Its ratio of ____________ would not change, however.

8. Through stock-for-stock acquisitions, the sharp rise in equity prices during the late 1990s was transformed into ____________, despite the usual assumption that ____________.

9. Unlike ____________, goodwill is not an asset that can be readily ____________ to raise cash. Neither can a company enter into a ____________ of its goodwill, as it can with its plant and equipment. In short, goodwill is not ____________ that management can either ____________ or ____________ to extricate itself from a financial tight spot.

10. A reasonable estimate of a low-profit company’s true equity value would be ____________.

11. Determining the cost of capital is a notoriously controversial subject in the financial field, complicated by ____________ and ____________.

12. Among the advantages of market capitalization as a measure of equity are:
   a. ____________
   b. ____________
   c. ____________

13. A limitation of the peer-group approach to valuation is that ____________, and therefore ____________, one major benefit of using ____________ as a gauge of actual equity value.
14. Instead of striving for theoretical purity on the matter, analysts should adopt a ____________, using the measure of equity value _____________.

15. Historical-cost-based balance sheet figures are the ones that matter in ____________, that a company will violate ____________ requiring ____________.

16. Users of financial statements can process only ____________, and they do not always have ____________.

17. Deterioration in a company’s financial position may catch investors by surprise because it ____________ and is ____________.

**CHAPTER 3: THE INCOME STATEMENT**

1. Students of financial statements must keep up with ____________ of the past few years in transforming ____________ into ____________.

2. In the ____________, each income statement item is expressed as ____________ (sales or revenues), which is represented as ____________.

3. Besides facilitating comparisons between a company’s present and past results, the ____________ can highlight important facts ____________.

4. Even within an industry, the breakdown of expenses can vary from company to company as a function of ____________ and ____________.

5. Percentage breakdowns are also helpful for comparing a single company’s performance with ____________ and for comparing ____________ on the basis of ____________.

6. In essence, Peet’s is more of ____________ and Starbucks is more involved in ____________.

7. Costs as percentages of sales also vary among companies within an industry for ____________, than differences ____________.

8. The more widely diversified pharmaceutical manufacturers can be expected to have ____________ percentage ____________, as well as ____________ percentage expenses, than industry peers that focus exclusively on ____________.
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9. Analysts must take care not to mistake difference that is actually ___________ as evidence of ___________. A subtler explanation may be available at the modest cost of ___________.

10. Executives whose bonuses rise ___________ have a strong incentive not only ___________, but also to use ___________.

11. On a retrospective basis, a surge ___________ or ___________ may indicate that ___________.

12. Along with ___________, another major expense category that can be controlled through ___________ is ___________.

13. An unusually low ratio of ___________ to ___________ with the ratios of its industry peers may indicate that management is being unrealistic in acknowledging the pace of wear and tear on fixed assets. Understatement of ___________ and overstatement of ___________ would result.

14. A company knows that creating ___________ expectations about ___________ can raise ___________ and lower ___________.

15. One way persuading investors that a major development that hurt earnings last year will ___________ affect earnings ___________ is to suggest that any ___________ suffered by the company was somehow ___________, and, by implication, ___________.

16. An extraordinary item is reported on an ___________ basis, below the ___________ from continuing operations.

17. The accounting rules prohibit corporate officials from displaying certain hits to earnings “above the line,” that is, ___________, and from using the label ___________. Accordingly they employ designations such as ___________ or ___________. These terms have ___________, but ___________ the highlighted items are ___________.

18. In recent years, ___________ has become a catchall for charges that companies wish analysts to consider ___________, but which do not qualify for ___________.

19. Corporate managers commonly perceive that ___________ will be ___________ if they take (for sake of argument) a $1.5 billion write-off than if ___________. The benefit of exaggerating the damage is that in subsequent years, ___________.

20. The most dangerous trap that users of financial statements must avoid walking into, however, is inferring that the term “restructuring” connotes ____________.

21. The purpose of providing pro forma results was to help analysts ____________ accurately when some event ____________ caused ____________, to convey a misleading impression.

22. Computer software producers got into the act by ____________ from the expenses considered in calculating ____________.

23. Unlike operating income, a concept addressed by FASB standards, ____________ is a number that subjectively ____________ many ____________, that lack any standing under GAAP.

24. In fact, analysts who hope to forecast future financial results accurately must apply ____________, and set aside genuinely ____________.

25. Analysts must exercise judgment when considering pro forma earnings; however, they must make sure to examine ____________, instead of ____________, by relying solely on ____________.

26. An older, but not obsolete, device for beefing up reported income is ____________.

27. A comparatively ____________ ratio of PP&E to ____________ or ____________ is another sign of potential trouble.

28. Management can ____________ through techniques that more properly fall into the category of ____________.

29. One way to increase profitability through ____________ involves ____________.

30. A corporation can easily accelerate its sales growth by ____________ and ____________. Creating genuine value for shareholders through ____________ is more difficult, although unwary investors sometimes fail to recognize the distinction.

31. Analysts need to distinguish between internal growth and external growth. ____________ consists of sales increases generated from a company’s existing operations, while ____________ represents incremental sales brought in through ____________.

32. If Company A generates external growth by acquiring Company B and neither Company nor its new subsidiary increases its profitability, then ____________, the merged companies is ____________ than the sum of the two companies’ values.
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33. In general, the __________ the combining businesses are, the __________ it is that the hoped-for economies of scope __________.

34. As synergies go, projections of economies of scale in combinations of companies __________ tend to be more plausible than economies of scope purportedly available to companies in __________ businesses.

35. A company with relatively large __________ has a __________ breakeven level. Even a modest economic downturn will reduce __________ below the rate required to keep the company profitable.

36. Deals that work on paper have often foundered on
   a. __________
   b. __________
   c. __________
   d. __________

37. Financial statements cannot capture certain __________ that may be essential to __________. These include
   a. __________
   b. __________
   c. __________

CHAPTER 4: THE STATEMENT OF CASH FLOWS

1. The present version of the statement that traces the flow of funds in and out of the firm, the statement of cash flows, became mandatory, under __________, for issuers with fiscal years ending after __________.

2. For financial-reporting (as opposed to __________) purposes, a publicly owned company generally seeks to maximize __________, which investors use as a basis for valuing its shares.

3. A privately held company, unlike a __________, which shows one set of statements to the public and another to the Internal Revenue Service, a private company typically prepares __________ of statements, with __________ foremost in its thinking. Its incentive is
not ____________, but to ____________, the income it reports, thereby ____________ its tax bill as well.

4. In a classic LBO, a group of investors acquires a business by ____________ and ____________ the balance.

5. The amount attributable to depreciation ____________ in the current year. Rather, it is a bookkeeping entry intended to represent the ____________, through use, ____________.

6. Viewed in terms of cash inflows and outflows, rather than earnings, ____________ begins to look like ____________.

7. Analysts evaluating the investment merits of the LBO proposal would miss the point if they focused on ____________ rather than ____________.

8. In an LBO, the equity investors do not reap spectacular gains without incurring significant _____________. There is a danger that everything ____________ and that they will lose ____________. Specifically, there is a risk that ____________ will fall short of expectations, perhaps as a result of ____________ or because the investors’ expectations ____________.

9. The ____________, rather than the ____________, provides the best information about a highly leveraged firm’s financial health.

10. Among the applications and uses of the Statement of Cash Flows are:
   a. ____________
   b. ____________
   c. ____________

11. When a company is ____________, its balance sheet may ____________ its asset value, as a result of ____________ having lagged the ____________ of the company’s operations.

12. Revenues build gradually during the ____________ phase, during which time the company is just ____________ and ____________.

13. Growth and profits accelerate rapidly during the ____________ phase, as the company’s products begin to penetrate the market and the ____________.

14. During the ____________ period, growth in sales and earnings decelerates as the _____________. In the ____________ phase, sales opportunities are limited to the replacement of products previously sold, plus _____________.

15. ____________
15. Price competition often intensifies at this stage, as companies _________. The _________ stage does not automatically follow maturity, but over long periods some industries do get swept away by _________.

16. Sharply declining sales and earnings, ultimately resulting in ________, characterize industries in decline.

17. ________ are typically voracious cash users.

18. ________ are start-ups that survive long enough to reach the stage of entering the public market.

19. For a company at ________, it may take several years for sales to reach ________ sizable fixed costs that are _________.

20. Unlike a ________, Green Mountain is _________. It issues substantial ________ each year to fund its ________.

21. ________ are in a less precarious state in terms of cash flow than their emerging growth counterparts.

22. Reflecting the ________ of its business, Kimberly-Clark generates a ________ level of ________.

23. Far from depending ________, this mature company ________, giving them the opportunity to ________ it in higher-growth, ________.

24. Some ________ choose instead to ________ internally. They either launch or acquire businesses with ________. The older businesses become ________ for funding the newer activities.

25. ________ are past the cash strain faced by growth companies that must fund large ________ programs.

26. ________ struggle to generate sufficient cash as a consequence of meager earnings.

27. By studying the cash flow statement, an analyst can make informed judgments on such questions as:
   a. ________
   b. ________
   c. ________

28. In difficult times, when a company must cut back on various expenditures ________, management faces many difficult choices. A key objective is to ________.
29. At times, ____________ becomes ____________, as a function ____________, or ____________. During the ____________ that occasionally befall the business world, ____________ is unavailable at any price.

30. If a corporation’s financial strain becomes acute, the board of directors may take the comparatively extreme step of ____________.

31. Reducing ____________ is a step that corporations try very hard to avoid, for fear of ____________ and consequently suffering an increase in ____________.

32. A final factor in assessing financial flexibility is the change in adjusted working capital. Unlike conventional working capital ____________, this figure excludes ____________, as well as ____________ and ____________.

33. A company with a strong balance sheet can fund much of that cash need by increasing its ____________ (credit extended by vendors). External financing may be needed, however, if accumulation of unsold goods causes ____________ to rise disproportionately to ____________. Similarly, if customers begin paying more slowly than formerly, can widen the gap between ____________ and ____________.

34. One typical consequence of violating ____________ or striving to head off ____________ is that management reduces discretionary expenditures to avoid ____________.

35. Overinvestment has unquestionably led, in many industries, to prolonged periods of ____________, producing in turn chronically ____________. In retrospect, the firms involved would have served their shareholders better if they had ____________ or ____________, instead of ____________.

36. Keeping cash “trapped” in marketable securities can enable a firm ____________ over “lean-and-mean” competitors when ____________ make it difficult to ____________.

37. Another less obvious risk of eschewing financial flexibility is the danger of permanently losing ____________ through ____________ occasioned by recessions.

38. The income statement is a dubious measure of the success of a ____________, company that is being managed to ____________ rather than ____________, reported profits.
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39. The cash flow statement is the best tool for measuring ____________, which, contrary to a widely held view, is not merely a security blanket for ____________.

40. In the hands of an aggressive but prudent management, a cash flow cushion can enable a company to ____________ when competitors are forced to cut back.

CHAPTER 5: WHAT IS PROFIT?

1. Profitability is a yardstick by which businesspeople can measure their ____________ and justify ____________.

2. When calculating ____________ profits, the analyst must take care to consider only genuine revenues and deduct all relevant costs.

3. There can be no bona fide profit without ____________. Bona fide profits are the only kind of profits ____________ in financial analysis.

4. Merely ____________, it is clear, does not increase wealth.

5. An essential element of genuinely useful financial statement analysis is: ____________.

6. The issuer of the statements can ____________ or ____________ its reported earnings simply by using its latitude to assume shorter or longer ____________.

7. The rate at which the tax code allows owners to write off property overstates ____________.

8. In the ____________, companies typically record depreciation and amortization expense that far exceeds physical wear-and-tear on assets.

9. In many industries, fixed assets consist mainly of ____________. The major risk of analytical error does not arise from the possibility that ____________, but the reverse.

CHAPTER 6: REVENUE RECOGNITION

1. Many corporations employ ____________ practices that comply with GAAP yet ____________.

2. Under intense pressure to maintain their stock prices, companies characterized by ____________ seem particularly prone ____________.
3. To seasoned investors, __________ by a senior manager represents __________.

4. Bonus-seeking managers may initially veer off the straight-and-narrow by __________ a small amount from __________, intending to __________ the following year, but they instead fall further and further behind. Eventually, the gap between __________ and __________ grows too large to sustain.

5. Even when an independent accounting firm certifies that a company’s financials __________ with generally accepted accounting principles; the analyst must stay alert for evidence __________.

6. Staying alert to evidence of flawed, __________, reporting is essential, even when the auditors __________.

7. As a rule, distorting one section of the financial statements __________. Assiduous tracking of a variety of __________ should raise serious questions about a company’s reporting, at a minimum.

8. The explanation for the sudden drop in projected earnings was that in 2001 Bristol-Myers __________ to induce them to __________ at a much faster rate than necessary to __________.

9. “_________” is a security analysts’ term for the financial reporting gimmick that Bristol-Myers employed __________.

10. Along with other pharmaceutical producers, Bristol-Myers was feeling profit pressures due to __________ to replace sales of products __________.

11. Haydon was known for speaking candidly about Bristol-Myers’s declining sales prospects. Consequently, his reassignment was __________.

12. Also suspect was Bristol-Myers’s repeated practice of __________ that exactly equaled __________.

13. The Bristol-Myers Squibb case study nevertheless illustrates the value of __________ against __________.

14. According to Take-Two management, the adjustment arose because the company __________ on some games it sold to “___________” but which were later __________ by Take-Two.
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15. ____________ to the lesson taught by many other cases of financial misreporting, it paid to accept the Take-Two ____________ assurances that the company’s business prospects ____________.

16. Take-Two shipped hundreds of thousands of video games to distributors ____________, ____________ booked the shipments ____________, then ____________ in later periods.

17. Encouragingly for users of financial statements, managers ____________ are often betrayed by ____________.

18. In layaway sales, customers reserve goods ____________, and then make additional payments over a specified period, ____________ when they have paid in full.

19. Prior to the change in accounting practice, which FAS 101 made mandatory, Wal-Mart booked layaway sales ____________. Under the new and more conservative method, the company began to recognize the sales ____________.

20. On the whole, Bally’s reported profit margins benefited from the increase in ____________ as a percentage of total revenues. The reported earnings, however, rested on assumptions regarding the percentage of customers who ____________.

21. As in any sales situation, aggressive pursuit of new business could result in ____________. On average, the newer members might prove to be ____________ or less committed to physical fitness than ____________.

22. There was no change in the accounting principle, namely ____________. In the case of a health club, members’ upfront fees represent ____________. Club operators should therefore recognize the revenue over the period in which ____________.

23. Under GAAP, the general requirement was to spread membership fees ____________. If a company offered refunds, it could not ____________ until the refund period expired, unless there was ____________ to enable management to ____________ estimate ____________, with reasonable confidence.

24. Under certain circumstances, a company engaged in long-term contract work can _____________. This result arises from GAAP’s solution to a mismatch commonly observed ____________. 
25. GAAP addresses the problem through the ____________, which permits the company to recognize revenue in ____________, rather than in line with its billing.

26. As is generally the case with ____________, taking liberties with the percentage-of-completion borrows ____________, making a surprise ____________ at some point.

27. The SEC claimed that management at Sequoia Systems inflated revenue and profits by:
   a. ____________
   b. ____________
   c. ____________

28. The SEC also claimed that management at Sequoia Systems profited from the scheme by ____________.

29. Loading the distribution channels consists of ____________ to accept larger shipments of goods than ____________.

30. Loading does not boost ____________, but merely shifts the timing of its ____________.

31. Inevitably, the underlying trend of final sales to consumers slows down, at least temporarily. At that point, the manufacturer’s growth in reported revenue will maintain its trend only ____________, relative to their sales. If the distributors balk, ____________, forcing a ____________, of previously recorded profits.

32. Krispy Kreme revised its senior executive compensation plan.¹ Henceforth, officers would receive ____________ unless the company ____________ in each quarter ____________.

33. In essence, according to the Wall Street Journal’s story, Krispy Kreme ____________ by taking money ____________.

34. Had Krispy Kreme instead ____________, it would have ____________. The catch is that an asset is supposed to be ____________. Terminated stores would not seem ____________.

35. Most, if not all, of the ____________ on Krispy Kreme’s ____________ appeared to have come from a ____________ transaction, rather than from ____________.

¹SEC v. Scott A. Livengood, John W. Tate, and Randy S. Casstevens. SEC Complaint against Scott A. Livengood, John W. Tate, and Randy S. Casstevens, May 4, 2009.
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36. Krispy Kreme increased the size of the corrections to its fiscal 2004 results. The previously undisclosed problems involved ____________, ____________, and ____________.

37. Krispy Kreme was ____________ fictitious earnings. Rather, the SEC complaint depicted a ____________, through a wide range of ____________, to beat ____________.

38. An exceptionally long record of ____________ or ____________ is a reason to ____________.

39. A second lesson of the Krispy Kreme case is that ____________ and ____________ often go hand in hand.

40. It is impossible to assess the quality of an internal investigation without information on the ____________, and the basis ____________.

41. Users of financial statements should not be intimidated by corporate ____________ that denounce allegedly irresponsible ____________.

42. In 2001, Halliburton adopted an even more aggressive approach to ____________. For some projects, Halliburton began reporting sales ____________. Previously, the policy was to book revenues ____________. In addition, the company began keeping some disputed bills on the books ____________. The previous policy was to refrain from a write-off only ____________.

43. Halliburton became more aggressive about ____________, a classic technique for ____________.

44. If earnings look suspiciously ____________ during a ____________ for the company’s industry, users of financial statements should ____________ explains the disparity.

45. A stock’s value is a function of expected ____________, which partly depend on the ____________ vis-à-vis its competitors’.

46. Generally, the initial response of corporate executives caught in a lie is ____________, but gratifyingly often, ____________.

47. Analysts who strive to go beyond routine ____________ can profit by seeking ____________, of corporate disclosure, even when ____________ have already placed ____________.

48. Sometimes, management ____________ revenue recognition in order to ____________, short-run profits. The motive for this paradoxical
behavior is a desire to report the sort of ____________ that equity investors reward with ____________.

49. Grace executives reckoned that with earnings already meeting Wall Street analysts’ forecasts, a windfall ____________ the company’s stock price. Such an inference would have been consistent with investors’ customary ____________ that they perceive to be generated by ____________.

50. Grace’s 1998 statement that its auditors had raised no objections to its accounting for the Medicare reimbursement windfall was true only ____________ that Price Waterhouse issued clean financials, based on materiality considerations. As a spokeswoman for the auditing firm pointed out, such an opinion ____________.

51. According to Michael Jensen: “Tell a manager that he will get a bonus when targets are realized and two things will happen”:  
   a. ______________________________________________________________________
   b. ______________________________________________________________________

52. All too often, companies wouldn’t be able to accomplish the frauds without ____________.

53. According to Jensen, almost every company uses a budget system that ____________ employees for ____________ and punishes them ____________. He proposes reforming the system by severing the link between ____________ and ____________.

54. Even in the case of the bluest of the blue chips, watching for rising levels of ____________ or ____________, relative to ____________, should be standard operating procedure.

55. When the revenues derived from ____________ fail to materialize, the managers may resort to ____________. The positive mental attitude that overstates revenues in the early stage ____________, however, than ____________ at a later point.

**CHAPTER 7: EXPENSE RECOGNITION**

1. Corporate managers are just as creative ____________ and ____________, the recognition of as they are in maximizing and speeding up ____________.
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2. Investors attach little significance to ____________ profits and losses in valuing stocks. Therefore, a public company has a strong incentive to ____________ into a one-time event and to ____________ nonrecurring into smaller pieces and ____________.

3. Nortel Networks illustrated ____________, one of the most ____________ of financial reporting.

4. Between September 2000 and ____________, Nortel's market capitalization sank by 99%, devastating ____________ that were heavily invested in its shares.

5. The company had to wave a ____________ with respect to ____________ by ____________ financial reports.

6. In addition to dashing hopes ____________, Nortel rattled the market by firing ____________ Dunn, ____________ Beatty, and ____________ Gollogly.

7. Nortel's management's credibility ____________ as the ____________ for producing definitive ____________.

8. Nortel's investigation, which previously had focused on ____________, had turned to ____________.

9. Incorrect recognition of that amount resulted from a combination of:
   a. ____________
   b. ____________
   c. ____________
   d. ____________

10. Nortel followed a strategy of ____________ in its money-losing period of 2001–2002. ____________ created ____________ that could be taken ____________.

11. Nortel’s experience shows that if a company ____________, it will have no compunction about ____________ through ____________.

12. An important takeaway from the Nortel case is that ____________ can prove ____________.

13. ____________ are another frequently abused element of ____________. General Motors’s fiddling with this device ____________ in the ____________ of financial reporting.

14. At issue in GM’s restatement was ____________ and ____________ from ____________.
15. GM said that some cash flows from ________ that should have been classified among its ________ were instead booked as ________.

16. This revelation puzzled accounting experts because the applicable rules were unambiguous. ________ or ________ fell into ________; ________ were included in ________.

17. GM Management said it had ________ it was leasing to car-rental companies, assuming they would be ________ more after those companies ________.

18. Ordinarily, a company’s stock price ________ when its reported earnings ________.

19. Freddie Mac steadfastly ________, that its handling of ________ was aimed at ________.

20. Even if it was true that ________, represented the ________, Freddie Mac’s ________, had a huge impact that even ________ could not detect ________.

21. Freddie Mac’s manipulation did not end there. Another ploy to ________, consisted of ceasing to use ________.

22. Companies can follow a variety of approaches in downplaying expenses such as:
   a. ________
   b. ________
   c. ________
   d. ________

CHAPTER 8: THE APPLICATIONS AND LIMITATIONS OF EBITDA

1. The impetus for trying to redirect investors’ focus to ________ or other variants has been ________ recorded by many “new economy” companies.

2. Users of financial statements had discovered certain limitations in net income as a ________. They observed that two companies in the same industry could report similar ________, yet have substantially different ________.
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3. Net income is not, to the disappointment of analysts, a standard by which every company’s ____________ can be compared.
4. The accounting standards leave companies considerable discretion regarding the ____________ they assign to their ____________. The same applies to amortization schedules for ____________.
5. For some companies, the sum of net income, income taxes, and interest expense is not equivalent to EBIT, reflecting the presence of such factors as ____________, below ____________.
6. Shifting investors’ attention away from traditional fixed-charge coverage and toward ____________ was particularly beneficial during the 1980s, when some buyouts were so ____________ that ____________, would not cover pro forma interest expense even in a good year.
7. Capital spending is likely to exceed depreciation over time as the company ____________ to accommodate ____________. Another reason that capital spending may run higher than depreciation is that newly acquired equipment may be ____________ than the old equipment being written off, as a function of ____________.
8. Delaying equipment purchases and repairs that are ____________ but not ____________, should inflict no lasting damage on the company’s ____________ provided the ____________ lasts for only a few quarters.
9. Depreciation is not available as a long-run source of cash for ____________. This was a lesson applicable not only to the extremely ____________ deals of the 1980s, but also to the more ____________ capitalized transactions of later years.
10. Beaver’s definition of cash flow was more stringent than ____________ since he did not add back either ____________ or ____________ to net income.
11. Beaver did not conclude that analysts should rely solely on the ____________, but merely that it was the single best ____________.
12. Some investment managers consider that the single ratio of ____________ (as they define it) to ____________ predicts bankruptcy better than all of ____________ quantitative and qualitative considerations combined.
13. Aside from __________, the amount of working capital needed to run a business represents a fairly constant __________ of a company’s sales. Therefore, if inventories or receivables __________ materially as a percentage of sales, analysts should strongly suspect that the earnings are __________, even though management will invariably offer a __________ explanation.

14. If a company resorts to stretching out its payables, two other ratios that will send out warning signals are:
   a. __________
   b. __________

15. Merrill Lynch investment strategist Richard Bernstein points out that __________ earnings tend to be more stable than __________ earnings, EBIT tends to be more stable than __________ earnings, and __________ tends to be more stable than EBIT.

16. Strategist Bernstein found that by attempting to __________ inherent in companies’ earnings, investors reduced the __________ of their stock selection.

CHAPTER 9: THE RELIABILITY OF DISCLOSURE AND AUDITS

1. Fear of the consequences of breaking the law keeps corporate managers in line. __________ the law is another matter, though, in the minds of many executives. If their bonuses depend on __________, they can usually see their way clear to adopting that course.

2. Technically, __________ appoints the auditing firm, but __________ is the point of contact in hashing out the details of presenting financial events for __________.

3. At some point, __________ becomes a moral imperative, but in the real world, accounting firms must be __________.

4. It is common for front-line auditors to balk at an __________ proposed by a company’s management, only to be overruled by __________.

5. __________ is an unambiguous violation of accounting standards, but audits do not __________.
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6. Extremely clever scamsters may even succeed in undermining the auditors’ efforts to select __________ a procedure designed to foil concealment of fraud.

7. When challenged on inconsistencies in their numbers, companies sometimes __________, rather than any intention to __________.

8. Seasoned followers of the corporate scene realize that companies are not always as __________ as investors __________.

9. According to president and chief executive of Trump World’s Fair Casino Hotel, the firm’s focus in 1999 was threefold:
   a. __________
   b. __________
   c. __________

10. Investors who relied solely on __________ by Trump World’s Fair Casino Hotel were burned if they bought into the rally that followed the __________ press release.

11. Abundant evidence has emerged over the years of corporate managers __________ to paint as rosy a picture as possible.

12. To say that __________, however, is quite different from saying that
   a. __________
   b. __________ are as good as __________
   c. __________
   d. __________

13. Popular outrage over the __________ accounting scandals created __________ to eliminate __________.

14. Systematic problems in the audit process arise not only __________ but also from __________ of __________.

15. In the 1990s, __________ emerged as a means of keeping a lid on costs. Instead of focusing on __________, they identified the areas that in __________ presented the greatest risk of error or fraud, such as __________. Incredibly, these judgments in some cases were based on __________.

16. In WorldCom’s early days, Arthur Andersen audited the company in __________. As the company grew, however, Andersen migrated toward __________. If a question arose about controls or procedures, Andersen relied on the __________.
17. Congress’s unwillingness to give the SEC ____________ reflected more than ____________ on _____________.
18. One final line of defense for users of a company’s financial statements is ____________. This protection has ____________ over the years.
19. In one of the few encouraging notes of recent years, the SEC has imposed a ____________ requirement on audit committee members.
20. Many companies are either ____________ or _____________.

   Rather than laying down the law (or GAAP), the auditors typically wind up ____________ to arrive at a point where they can convince themselves that ____________ have been satisfied.
21. Given the observed gap between ____________ and ____________ in financial reporting, users of financial statements must provide themselves ____________ through tough _____________.

CHAPTER 10: MERGERS-AND-ACQUISITIONS ACCOUNTING

1. Choosing a method of accounting for a merger or acquisition does not affect the combined companies’ subsequent ____________ or _____________. The discretionary accounting choices can have a ____________, however, on _____________.
2. Meyer emphasized that he was ____________ Tyco _____________, but merely of _____________. Nevertheless, the diversified manufacturer responded in the _____________; Tyco angrily denounced Meyer’s report, stating that _____________.
3. Alert analysts had suspected something was going on behind the scenes. They questioned why in the most recent fiscal year, ____________ to Tyco’s ____________ doubled to $21.6 billion even though the company reported $4.8 billion _____________.
4. Swartz acknowledged that the amount spent on ____________ was not determinable from Tyco’s financial statements because it reported ____________ and did not disclose the _____________.
5. The investigators concluded that Tyco repeatedly used aggressive, ____________, including ____________, immediately before acquisition, in order to generate _____________. Company officials referred
Questions on Each Chapter

to such practices as ____________ and ordered employees to “create stories” to justify ____________.

6. Tyco’s financial reporting aggressiveness involved ____________ through a nonstandard definition of the term. Tyco excluded ____________ and ____________ for its ADT security-alarm business, labeling the latter ____________.

7. Although the pooling-of-interests method has been abolished, M&A accounting remains an area in which analysts must be on their toes. Companies have developed ____________ for exploiting the discretion afforded by the rules. ____________ in the post-acquisition period remains a key objective.

8. For example, one M&A-related gambit entails the GAAP-sanctioned use, for financial reporting purposes, of ____________. Typically, companies use this discretion to simplify the closing of their books at month- or quarter-end.

9. Under Securities and Exchange Commission rules, companies do not have to ____________ to reflect the revenues and earnings of acquired businesses ____________.

10. There can be no guarantee of loans secured by stock issued in the combination, which would effectively ____________ implicit in a bona fide ____________. ____________ of stock, and are likewise prohibited.

11. Regulators may tighten up rules that can be abused, such as the ____________, but corporate managers usually manage to stay one step ahead. Analysts who hope to keep pace would do well to study ____________ in order to understand the thought process of the field’s most notorious innovators.

12. Clues to hanky-panky may include:
   a. ____________
   b. ____________, and, if an acquired company was a public reporter prior to its acquisition
   c. ____________
CHAPTER 11: IS FRAUD DETECTABLE?

1. Beneish defines manipulation to include both ______________ and ______________ within GAAP.

2. Beneish finds, by statistical analysis, that the presence of any of the following five factors increases the probability of earnings manipulation:
   1. ______________
   2. ______________
   3. ______________
   4. ______________
   5. ______________

3. The evidence of criminal misrepresentation ______________, but ______________ definitively identified some of the most famous frauds ______________ and the companies ______________.

4. In studying these notorious frauds, readers should pay close attention ______________, but also ______________ as the validity of their stated profits is challenged.

5. Unexpected ______________ is a classic warning sign of financial misrepresentation.

6. When Enron at long last conceded that it was overly indebted, management tried to:
   a. ______________
   b. ______________
   c. ______________
   d. ______________

7. Enron also misled investors by aggressively exploiting wiggle room in the accounting rules. The company booked revenue from its energy-related derivatives contracts on the basis of ______________, rather than ______________, as is the norm for ______________.

8. Excessive liberties with ______________ accounting rules constituted yet one more element of Enron’s misrepresentation.

9. On a conference call dealing with Enron’s earnings, analyst Richard Grubman complained that the company was ______________ in refusing to include a ______________ in its earnings release.
Questions on Each Chapter

10. Still, the ____________ vehicles, combined with ____________ disclosures, enabled Enron to make itself look less ____________ than it really was.

11. While Enron grossly misled investors by ____________, a large part of its deception consisted of ____________ of basic accounting standards, with ____________ of its auditor.

12. Equally crude was a scheme in which Enron reportedly borrowed $500 million from a bank and ____________. A few days later it sold ____________, and repaid the bank, reporting the proceeds from the meaningless transaction as ____________.

13. The ____________ of Enron’s ____________ was a major concern. “Ultimately they’re telling you ____________, but they’re not telling you ____________” Business Valuation Services analyst Stephen Campbell complained. “That is essentially saying ‘___________.’”

14. Off Wall Street Consulting group recommended a short sale of Enron based on two factors identifiable from the financial statements, namely, ____________ and ____________ with ____________.

15. Analysts should be especially wary when ____________, as indicated by tools such as ____________, coincides with ____________ financial reporting.

16. According to the SEC’s complaint, HealthSouth’s falsification began ____________.

17. Flat denial by Scrushy, regardless ____________, was a consistent theme as the ____________ unfolded.

18. The complaint stated that when HealthSouth officials and accountants urged Scrushy ____________, he replied, in effect, “___________.”

19. The “Sarbox” provision requiring CFOs and CEOs to attest to the accuracy of financial statements gave prosecutors a powerful weapon to wield against falsifiers, but ____________ dispelled any notion that the tough new law ____________.

20. HealthSouth exaggerated its earnings by understating the gap between ____________ and ____________.

21. If the auditors did question an accounting entry, HealthSouth executives reportedly ____________ to validate the item.
22. HealthSouth also propped up profits by failing to ___________ with ___________. In addition, the company ___________ when it sold assets ___________.

23. Compounding Scushy’s legal problems, federal prosecutors disclosed in July 2003 that they had uncovered evidence of:
   a. ___________
   b. ___________
   c. ___________
   d. ___________
   e. ___________

24. The most dismaying aspect of the performance of HealthSouth’s auditor, Ernst & Young LLP, was ___________ to challenge a ___________ in cash.

25. In the view of experts in the field, internal checks and balances also broke down at HealthSouth. The board’s audit committee met ___________ during 2001, ___________ than the minimum recommended by the SEC.

26. Investors had little official warning of trouble until ___________. Parmalat’s collapse. As late as October 2003, Deutsche Bank’s equity research group rated the company’s stock ___________, highlighting ___________, and Citibank put out ___________ report in November. Furthermore, the company’s debt carried an ___________ rating up until ___________ the bankruptcy filing.

27. A major red flag was Parmalat’s ___________, despite claiming to have a ___________.

28. Merrill Lynch analysts downgraded Parmalat to SELL, saying that the company’s ___________, while reporting ___________, threw into question ___________.

29. Another hazard signal emerged on February 26, 2003, when Parmalat suddenly canceled its plan ___________. The company said it would instead ___________, suggesting the market had less confidence in Parmalat’s ___________ than management had thought.

30. Oddly, the person who achieved the greatest renown for early recognition of the Parmalat’s house of cards was ___________, but a ___________.

Questions on Each Chapter

CHAPTER 12: FORECASTING FINANCIAL STATEMENTS

1. It is _____________ that determine the value of a company’s stock and the _____________ that determines credit quality.

2. The process of financial projections is an extension of _____________ and _____________, based on assumptions about future _____________, _____________, and _____________.

3. Sales projections for the company’s business can be developed with the help of such sources as _____________, _____________, and firms that sell _____________ models.

4. Basic industries such as _____________, _____________, and _____________ tend to lend themselves best to the _____________ described here. In technology-driven industries and “hits-driven” businesses such as _____________ and _____________, the connection between _____________ and the _____________ will tend to be looser.

5. The expected intensity of industry competition, which affects a company’s _____________ on to customers or to retain _____________, influences the _____________ forecast.

6. Since the segment information may show only operating income, and not _____________, the analyst must add _____________ to operating income, then make assumptions about the allocation of _____________, _____________, _____________, and _____________ expense by segment.

7. The R&D percentage may change if, for example, the company _____________ in an industry that is either significantly more, or significantly less, _____________ than its existing operations.

8. The key to the forecasting interest expense method employed here is to estimate the firm’s embedded cost of debt, that is, the _____________ on the company’s _____________.

9. Accurately projecting interest expense for _____________ companies is important because _____________ may depend on the size of _____________ they must cover each quarter.

10. The completed income statement projection supplies _____________ of the projected statement of cash flows.
11. Before assuming a constant-percentage relationship, the analyst must verify that __________.

12. A sizable __________ might be presumed to be directed toward share repurchase, reducing __________, if management has indicated a desire to __________ and is __________ by its board of directors.

13. Typically, the analyst must modify the underlying __________ assumptions, and therefore the projections, several times during the year as __________ diverges from __________.

14. A firm may have considerable room to cut __________ in the short run if it suffers a decline in funds provided by __________. A projection that ignored this could prove overly pessimistic.

15. An interest rate decline will have limited impact on a company for which interest costs represent a __________. The impact will be greater on a company with a large interest cost component and with much of its debt at __________. This assumes the return on the company’s assets is __________.

16. Analysts are generally not arrogant enough to try to forecast the figures accurately to the first decimal place, that is, to the __________ for a company with revenues in the __________.

17. It is generally inappropriate to compare a __________ item (EBITDA) with a balance sheet figure, especially in the case of a __________ company.

18. It is unwise to base an investment decision on historical statements that antedate a major financial change such as:
   a. __________
   b. __________
   c. __________
   d. __________

19. A pro forma income statement for a single year provides no information about __________ in sales and earnings of __________ that is being spun off.

20. Pro forma adjustments for a divestment do not capture the potential benefits of increased __________ on the company’s __________.

21. The earnings shown in a merger-related pro forma income statement may be higher than the company can sustain because:
Questions on Each Chapter

a. The acquired company’s owners may be shrewdly selling out at top dollar, anticipating a ____________ that is foreseeable by ____________, but not to the acquiring corporation’s management.

b. Mergers of companies in the same industry often work out poorly due to ____________.

c. Inappropriately applying ____________ to an industry with very different requirements.

22. A ____________ investor buying a 30-year bond is certainly interested in the issuer’s financial prospects beyond ____________. Similarly, a substantial percentage of the present value of future dividends represented by a stock’s price lies ____________.

23. Radical financial restructurings such as ____________, ____________, and ____________ necessitate ____________ projections.

24. Of the various types of analysis of financial statements, projecting ____________ and ____________ requires the greatest skill and produces ____________.

25. The lack of ____________ is what makes financial forecasting so ____________. When betting huge sums in the face of ____________, it is essential that investors understand ____________ as fully as they possibly can.

CHAPTER 13: CREDIT ANALYSIS

1. Financial statements tell much about a borrower’s ____________ to repay a loan, but disclose little about the equally important ____________ to repay.

2. If a company is dependent on raw materials provided by a subsidiary, there may be a ____________ presumption that it will stand behind the subsidiary’s ____________, even ____________.

3. Illiquidity manifests itself as an excess of current ____________, over ____________. The ____________ ratio gauges the risk of this occurring by comparing the claims against the company that will become
payable during ____________ with the assets that are already in the form of cash or that will be converted to cash during ____________.

4. The greater the amount by which asset values could deteriorate, the greater the ____________, and the greater the creditor’s sense of ____________. Equity is by definition ____________ minus ____________.

5. Aggressive ____________ frequently try to satisfy the letter of a ____________ leverage limit imposed by lenders, without fulfilling the ____________ behind it.

6. A firm that “zeros out” its ____________ at some point in each operating cycle can legitimately argue that its “true” leverage is represented by the ____________ on its balance sheet.

7. Current maturities of long-term debt should enter into the calculation of ____________, based on a conservative assumption that the company will replace maturing debt with ____________.

8. Exposure to interest rate fluctuations can also arise from long-term ____________. Companies can limit this risk by using ____________.

9. Public financial statements typically provide ____________ information about the extent to which the issuer has ____________ its exposure to interest rate fluctuations through ____________.

10. Analysts should remember that the ultimate objective is not to ____________ but to ____________.

11. In general, the credit analyst must recognize the heightened level of risk implied by the presence of preferred stock in the ____________. One formal way to take this risk into account is to calculate the ratio of ____________ to ____________.

12. In addition to including capital leases in the total debt calculation, analysts should also take into account the ____________ liabilities represented by contractual payments on ____________, which are reported as ____________ in the ____________ to Financial Statements.

13. A corporation can employ leverage yet avoid showing debt on its consolidated balance sheet by ____________ or forming ____________.

14. Under SFAS ____________, balance sheet recognition is now given to pension liabilities related to employees’ service to date. Similarly, SFAS
Questions on Each Chapter

... requires recognition of postretirement health care benefits as an on-balance sheet liability.

15. The precise formula for __________ a ratio is less important than the assurance that it is __________ for all companies being evaluated.

16. In general, credit analysts should assume that the achievement of __________ bond ratings is a __________ goal of corporate management.

17. The contemporary view is that profits are ultimately what sustain __________ and __________. High profits keep plenty of cash flowing through the system and confirm the value of productive assets such as __________ and __________.

18. The cumulative effect of a change in accounting procedures will appear __________ or after __________ have already been deducted. The sum of net income and provision for income taxes will then differ from the __________ that appears in the income statement.

19. Operating margin shows how well management has run the business __________, wisely, controlling __________, before taking into account financial policies, which largely determine __________, and __________, which is outside management’s control.

20. Fixed-charge coverage is an __________ ratio of major interest to credit analysts. It measures the ability of a company’s __________ to meet the __________ on its debt, the lender’s most direct concern. In its simplest form, the fixed-charge coverage ratio indicates the __________ by which __________ suffice to pay __________.

21. Regardless of whether it is __________ or __________, however, all interest accrued must be covered by __________ and should therefore appear in the __________ of the fixed-charge coverage calculation.

22. The two complications that arise in connection with incorporating operating lease payments into the fixed-charge coverage calculation are:

   a. __________

   b. __________

23. Companies sometimes argue that the denominator of the fixed-charge coverage ratio should include only __________ expense, that
is, the difference between ___________ and income derived from ___________, generally consisting of marketable securities.

24. Ratios related to sources and uses of funds measure credit quality at the most elemental level—a company’s ability to ___________.

25. Given corporations’ general reluctance to sell new equity, a recurrent cash shortfall is likely to be made up with ___________ financing, leading to a rise in ___________ ratio.

26. A company that suffers a prolonged downtrend in its ratio of ___________ is likely to get more deeply into debt, and therefore become ___________ with each succeeding year.

27. Unlike earnings, ___________ is essentially a programmed item, a cash flow assured by the accounting rules. The higher the percentage of cash flow derived from ___________, the higher is the ___________ of a company’s cash flow, and the ___________ its financial flexibility on the vagaries of the marketplace.

28. Analysts cannot necessarily assume that all is well simply because capital expenditures consistently exceed depreciation. Among the issues to consider are:
   a. ___________
   b. ___________
   c. ___________
   d. ___________

29. A limitation of combination ratios that incorporate balance-sheet figures is that they have little meaning if ___________.

30. The underlying notion of a turnover ratio is that a company requires a certain level of ___________ and ___________ to support a given volume of sales.

31. A ___________ is a possible explanation of declining inventory turnover. In this case, the inventory may not have suffered a severe reduction in value, but there are nevertheless unfavorable implications for ___________. Until the inventory glut can be worked off by ___________ to match the lower ___________, the company may have to borrow to finance its unusually high working capital, thereby increasing its ___________.

32. Fixed-charge coverage, too, has a weakness, for it is based on ___________, which are subject to considerable manipulation.
Questions on Each Chapter

33. Built from two comparatively hard numbers, the ratio of ____________ to ____________ provides one of the best single measures of ____________.

34. Expected ____________ have an important bearing on the decision to ____________ or ____________ credit, as well as on the ____________ of debt securities.

35. Line of business is another basis for defining ____________.

36. Beyond a certain point, calculating and comparing companies on the basis of ____________ financial ratios contributes little ____________.

37. ____________ or ____________ financial ratios can have different implications for different companies.

38. Quantitative models such as Zeta, as well as others that have been devised using various mathematical techniques, have several distinct benefits such as:
   a. ____________________________________________________________________
   b. ____________________________________________________________________
   c. ____________________________________________________________________

39. Like the quantitative models consisting of ____________, the default risk models based on stock prices provide useful, but ____________, signals.

CHAPTER 14: EQUITY ANALYSIS

1. In this chapter, the discussion focuses primarily on the use of financial statements in ____________.

2. Of the methods of fundamental common stock analysis, no other approach matches the intuitive appeal of regarding the stock price as the ____________ of expected ____________ dividends. This approach is analogous to the ____________ calculation for a bond and therefore facilitates the comparison of different ____________ of a single ____________.

3. By thinking through the logic of the ____________ method, the analyst will find that value always comes back to ____________.
4. The company’s earnings growth rate may diverge from its sales growth due to changes in its ____________.
5. As a rule, a ____________ company will not increase its dividend on a regular, annual basis.
6. Many analysts argue that ________________, rather than ________________, is the true determinant of dividend-paying capability.
7. Cash generated from ________________, which is generally more difficult for companies to manipulate than ________________, can legitimately be viewed as the preferred measure of future ____________.
8. The ability to vary the ________________, and therefore to assign a ________________ or ________________ multiple to a company’s earnings, is the equity analyst’s defense against earnings ____________ by management.
9. It is appropriate to assign an ________________ discount factor to the earnings of a company that competes against larger, better-capitalized firms. A small company ________________ of depth in management and concentration of ________________.
10. A building-materials manufacturer may claim to be cushioned against fluctuations in housing starts because of a strong emphasis in its product line on ________________.
11. Analysts should be especially wary of companies that have tended to jump on the bandwagon of ________________ associated with the ________________ of the moment.
12. Earnings per share will not grow merely because ________________.
13. Leverage reaches a limit, since lenders will not continue advancing funds beyond a certain point as ________________.
14. One way to increase earnings per share is to ________________.
15. To the extent that the company funds share buybacks with idle cash, the increase in ________________ is offset by a reduction arising from ________________.
16. Like most ratio analysis, the Du Pont Formula is valuable not only for ________________ but also for ________________.
17. Besides introducing greater volatility into the ________________, adding debt to the balance sheet demonstrates ________________.
Questions on Each Chapter

18. Some companies have the potential to raise their share prices by ____________, while others can increase their value by ____________.

19. Management’s main adversaries in battles over ____________ were aggressive ____________.

20. At least in the early stages, before some raiders became overly aggressive in their financial forecast assumptions, it was feasible to extract value without creating undue bankruptcy risk, simply by ____________.

21. In future bear markets, when stocks again sell at depressed price-earnings multiples, investors will probably renew their focus on ____________.

22. A leveraged buyout can bring about improved profitability for either of two reasons:
   a. ________________________________________________________________________
   b. ________________________________________________________________________

23. Today’s ____________ may be a precursor of tomorrow’s bankruptcy by a company that has economized its way to ____________.

24. A focus on ____________ multiples, the best-known form of fundamental analysis, is not the investor’s ____________ to relying on technicians’ stock charts.

25. For the investor who takes a longer view, ____________ provides an invaluable reference point for valuation.