

PART

One

Questions

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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.

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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.

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. 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.

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.

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.

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":
- _____
 - _____
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 _____.

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 *integrity* 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 _____.

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 _____.

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. _____
 - c. _____ are as good as _____
 - 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

- 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.

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 Scrusby, regardless _____, was a consistent theme as the _____ unfolded.
18. The complaint stated that when HealthSouth officials and accountants urged Scrusby _____, 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 _____.

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:

- 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

- _____ 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.

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

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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.

