

True-False

1. Financial accounting numbers can be used to define contract terms and monitor compliance with contract terms.
2. An essential feature of the modern corporation and most business relationships is the delegation of financial reporting responsibility.
3. When one party to a business relationship can make decisions that benefit him or her but harm the other party a conflict of interest arises.
4. One low-cost, effective way of eliminating or reducing conflicts of interest in business relationships is to use lawyers to negotiate all terms.
5. Debt covenants benefit creditors because the covenants reduce default risk.
6. Affirmative covenants stipulate actions the borrower must take.
7. A Certificate of Compliance affirms the creditor's managers have reviewed the financial statements and found no violation of any covenant provision.
8. A payment default occurs when the borrower violates one or more loan covenants but has made all principal and interest payments.
9. Management tends to make accounting changes and to manipulate discretionary accruals that increase income in order to avoid violating debt covenants.
10. A covenant that specifies a required minimum level of net worth and working capital is a compliance covenant.
11. Potential conflicts of interest between managers and owners can be overcome if compensation packages are tied to improvement in firm value.
12. Long-term incentives motivate and reward executives for the company's growth and prosperity in three to seven years.
13. Stock options are the most common short-term incentive device.
14. Phantom stock has all the characteristics of restricted stock, except that the executive receives the cash value of all the shares, not the shares themselves.
15. The methods and procedures that must be followed for financial statements that are utilized by regulatory agencies are known as RAP.
16. In the banking industry, the ratio of invested capital/gross assets, as defined by RAP, is the capital asset ratio.
17. A bank's estimated bad debt expense associated with its loan receivables is the loan loss provision.
18. IRS regulations govern the computation of net income for the SEC.
19. Potential earnings surprises are also known as accounting torpedoes.
20. Asset substitution transfers wealth from shareholders to creditors.
21. Creditors have a more serious problem when an investment has a high

risk and the expected value of the project is lower than the alternative project.

22. Loan provisions that are specifically designed to restrict asset substitution are called debt covenants.

Multiple-Choice Questions

Select the best answer from those provided.

23. A lender may be protected from deterioration of the borrower's credit risk if the commercial lending agreement requires the borrower to maintain a
 - a. current ratio above a certain level.
 - b. return on assets above a certain level.
 - c. specified return on equity.
 - d. specified accounts receivable turnover.
24. When one party to a business relationship can make decisions that benefit him or her but harm the other party a
 - a. lawsuit is automatically filed.
 - b. contract arises.
 - c. conflict of interest arises.
 - d. contingent liability arises.
25. One low-cost, effective way of eliminating or reducing conflicts of interest in business relationships is to
 - a. only deal with related parties.
 - b. carefully specify the mutual expectations in the contract terms.
 - c. use lawyers to negotiate all terms.
 - d. use an arbitrator for all negotiations.
26. A covenant that specifies a required minimum level of net worth and working capital is a/an
 - a. compliance covenant.
 - b. financial covenant.
 - c. implicit covenant.
 - d. negative covenant.
27. A financial covenant stipulates all of the following except
 - a. financial statements must be prepared in accordance with GAAP.
 - b. specific levels of performance to be met.
 - c. which accounting methods are to be used.
 - d. conditions that must be met.
28. A requirement to maintain a certain level of fixed charge coverage

- a. directly enhances a company's ability to pay dividends.
 - b. indirectly enhances a company's ability to pay dividends.
 - c. directly limits a company's ability to pay dividends.
 - d. indirectly limits a company's ability to pay dividends.
29. Covenants that place direct restrictions on managerial decisions are called
- a. positive restrictions.
 - b. positive covenants.
 - c. negative restrictions.
 - d. negative covenants.
30. Which one of the following is an example of a negative covenant?
- a. Compliance with laws
 - b. Maintenance of insurance
 - c. Limit on capital expenditures
 - d. Rights of inspection
31. The section of a loan agreement that describes circumstances in which the creditor has the right to terminate the lending relationship is called the
- a. events of compliance section.
 - b. certificate of compliance section.
 - c. events of termination section.
 - d. events of default section.
32. The failure of a company to pay other debts, such as payables or other loans, when due is called
- a. routine default.
 - b. non-default.
 - c. cross default.
 - d. compliance default.
33. According to the SEC any breach of a loan covenant that existed at the balance sheet date that has not subsequently been cured should
- a. be recorded as an adjustment to the financial statements.
 - b. be disclosed in the notes to the financial statements.
 - c. be disclosed in the audit report.
 - d. not be disclosed.
34. When a debt covenant is violated, the related debt must be classified as current if it is
- a. probable that the borrower will not be able to cure the default in the next twelve months.
 - b. possible that the borrower will not be able to cure the default in the next twelve months.
 - c. likely that the borrower will not be able to cure the default in the next twelve months.
 - d. reasonably likely that the borrower will not be able to cure the default in the next twelve months.
35. When a borrower is unable to make a scheduled interest payment, the type of default that occurs is a
- a. technical default.
 - b. covenant default.
 - c. payment default.
 - d. transitory default.
36. A study examining how incentives arising out of debt contracts affect managers' accounting choices found that the most common violations of accounting-based covenants occurred with
- a. net worth and working capital restrictions.
 - b. mergers and acquisitions restrictions.
 - c. leveraged buyout restrictions.
 - d. debt restructures.
37. Discretionary accounting accruals are
- a. cash financial statement adjustments, which accrue revenue or expenses.
 - b. noncash financial statement adjustments, which accrue revenue or expenses.
 - c. cash financial statement adjustments, which accrue only revenue.
 - d. noncash financial statement adjustments, which accrue only expenses.
38. In a study of discretionary accounting accruals, it was found that abnormal accruals in the year prior to reporting covenant violations were
- a. equal to other years.
 - b. lower than normal.
 - c. higher than normal.
 - d. not determinable.
39. Studies seem to suggest that management tends to make accounting changes and/or manipulate discretionary accruals to
- a. enhance technical defaults.
 - b. eliminate debt covenants.
 - c. violate debt covenants.
 - d. avoid violation of debt covenants.

40. Potential conflicts of interest between shareholders and managers may be overcome if managers are given incentives which cause them to behave as if they were
- creditors.
 - owners.
 - debtors.
 - vendors.
41. Share price may be increased as a result of a decrease in market-wide interest rates because of a/an
- increase in the cost of equity capital.
 - decrease in the cost of equity capital.
 - increase in the cost of debt.
 - decrease in the demand for fixed-rate bond investments.
42. Compensation incentives that motivate and reward executives for five years of growth and prosperity are called
- base salaries.
 - short-term incentives.
 - long-term incentives.
 - executive compensation packages.
43. Incentive stock options
- have value only if the market price of the stock declines.
 - have value only if the market price of the stock rises.
 - are taxed at ordinary rates.
 - do not qualify for favorable tax treatment.
44. An award of stock that is not transferable or subject to forfeiture for a period of years is called
- phantom stock.
 - treasury stock.
 - restricted stock.
 - preferred stock.
45. Most executive compensation plans link bonus awards to one or more
- non-accounting based performance measures.
 - accounting based performance measures.
 - marketing based performance measures.
 - management based performance measures.
46. The widespread use of accounting-based incentives for executive compensation is controversial for which one of the following reasons?
- Earnings growth does not automatically increase shareholder value.
 - Accounting based incentive plans can encourage managers to adopt a long-term business focus.
 - Executives cannot use their discretion over the accounting policies.
 - Managers do not have accounting flexibility.
47. The widespread use of accounting-based incentives to determine executive compensation is controversial for which one of the following reasons?
- Earnings growth automatically increases shareholder value.
 - Accounting based incentive plans can encourage managers to adopt a long-term business focus.
 - Executives can use their discretion over the accounting policies.
 - Managers do not have accounting flexibility.
48. Research has shown that research and development expenditures during the years immediately prior to a CEO's retirement tend to
- increase by a large amount.
 - increase by a small amount.
 - decline.
 - show no change.
49. Compensation plans should
- not link incentive plans to financial performance.
 - not be based on long-term business goals.
 - align shareholders' incentives with the objectives of managers.
 - align managers' incentives with the objectives of shareholders.
50. Long-term incentive components of executive compensation plans should include stock options
- to enhance the short-term focus of executives.
 - to enhance the long-term focus of executives.
 - to mitigate the long-term focus of executives.
 - to encourage better performance by low-level staff.
51. A compensation committee should be comprised of
- the CEO and the CFO of the company.
 - the CEO of the company and the outside attorney.
 - members of the Board of Directors who are also officers of the company.
 - members of the Board of Directors who are outside (non-management) directors.

52. Regulatory accounting principles are important to those outside the regulatory agencies because
- GAAP may allow reporting for assets and liabilities consistent with the way in which regulators establish rates.
 - GAAP does not allow reporting for assets and liabilities consistent with the way in which regulators establish rates.
 - regulatory accounting principles are not compatible with GAAP.
 - the SEC requires them.
53. Banks that fail to comply with regulations, including the failure to maintain an adequate capital adequacy ratio, face
- higher costs.
 - lower costs.
 - mergers and expansion of services.
 - incarceration of officers.
54. The use of a bank manager's discretion in the timing and amount of loan loss provisions and loan charge-offs can falsely understate the losses and
- decrease net income.
 - decrease bank obligations.
 - improve the bank's debt adequacy ratio.
 - improve the bank's capital adequacy ratio.
55. In the banking industry, the ratio of invested capital/gross assets, as defined by RAP, is the
- capital asset ratio.
 - capital adequacy ratio.
 - gross asset ratio.
 - indirect capital ratio
56. A bank's estimated bad debt expense associated with its loan receivables is the
- loan loss provision.
 - loan charge-offs.
 - allowance for loans.
 - accumulated loan loss.
57. In the utilities industry, rate formulas are established to allow the utilities to set total allowed revenues to recover
- only the administrative costs of operations.
 - only the operating costs associated with operations.
 - all operating costs, depreciation, taxes, and a fair return on invested capital.
 - all operating costs other than depreciation and taxes, and a fair return on invested capital.
58. In the utilities industry, image advertising and customer safety advertising are
- both paid for by customers.
 - both paid for by shareholders.
 - both treated as operating expenses under RAP.
 - both treated as operating expenses under GAAP.
59. Rate regulation provides incentives for public utility managers to
- artificially decrease the asset base.
 - artificially increase the asset base.
 - artificially decrease operating expenses.
 - artificially decrease taxes.
60. IRS regulations govern the
- computation of net income for GAAP.
 - computation of net income for tax purposes.
 - computation of gross profit for GAAP.
 - computation of net income for the SEC.
61. Potential earnings surprises are also known as accounting
- torpedoes.
 - hurricanes.
 - cyclones.
 - typhoons.
62. An example of an accounting torpedo is a
- depreciation expense.
 - stock option plans.
 - major write-off of bad debts.
 - recurring event of the company.
63. When a company has differing investment project possibilities with the same dollar cost and the same expected return over the same investment horizon, a creditor would prefer the investment with
- the highest risk.
 - lowest potential for return.
 - lower dispersion of potential returns.
 - higher dispersion of expected returns.
64. All other things equal, stockholders of companies with debt financing prefer investment projects with

- a. equal dispersion of potential returns.
 - b. high dispersion of potential returns.
 - c. low dispersion of potential returns.
 - d. no dispersion of potential returns.
65. All other things equal, creditors of companies with debt financing prefer investment projects with
- a. high dispersion of potential returns.
 - b. low dispersion of potential returns.
 - c. greater risk of dispersion of returns.
 - d. absolute risk of potential returns.
66. Creditors have a more serious problem when an investment has a high risk and the expected value of the project is
- a. lower than the alternative project.
 - b. higher than the alternative project.
 - c. easily determinable.
 - d. higher than any other similar project.
67. Loan provisions that are specifically designed to restrict asset substitution are called
- a. debt covenants.
 - b. debt obligations.
 - c. credit covenants.
 - d. credit agreements.

Essay and Computational Questions

68. Refer to the following excerpts from an April 3rd, 1996 article, entitled "Former Executive Claims Mattel Inflated Sales and Used Questionable Accounting," from The Wall Street Journal.

The accusations, raised in a little-noticed whistle-blower lawsuit filed by a disgruntled former senior vice president, and confirmed in part by another former Mattel marketing executive, raise questions about whether management tried to mislead analysts and investors, particularly in connections with its business dealings with Walt Disney Co.

By using suspect methods to boost revenue and reduce costs, the suit contends, management was able to meet aggressive corporate growth targets for 1994, while earning tens of millions of dollars in incentive pay. Mattel's top five executives collected almost \$12 million in sales-linked incentive awards for that year, alone...

While the partnership with Disney has been a major engine for Mattel's growth, providing more than \$400 million in annual revenue, internal Mattel files indi-

cate that many toys licensed from Disney in fact have been steady money losers stretching back to the 1980s.

The infant and preschool toys it makes using Disney characters, for example, haven't made any profit since at least 1988. And Mattel's own projections indicate that those lines are likely to continue in the red unless Disney agrees to sharply reduce its royalty requirements – something that Disney has balked at doing...

The suit alleges that Mattel's top leadership, including Ms. Barad and John Amerman, its chairman, misled the public and violated state and federal laws for a period of years by disguising the true cost of doing business.

The result was "material overstatement in virtually all of the targeted financial results" used to determine incentive and stock-option awards, as well as filings with the Securities and Exchange Commission and information provided to shareholders, the latest filing in the suit contends...

Specifically, the lawsuit focuses on more than \$17 million in royalty payments to Disney that Mattel failed to pay on time and also allegedly failed to properly account for during 1994. By not accruing the cost of those obligations in its 1994 accounts, the lawsuit alleges, Mattel's fourth-quarter earnings were overstated by more than 15%. The lawsuit doesn't allege that Disney knew about the alleged infraction or did anything improper....

Required:

1. Explain how the article provides an example of the contracting role of accounting.
2. Explain how the article provides an example of the valuation role of accounting.
3. Explain how the concepts of revenue recognition and matching are illustrated in the article.
4. The excerpt states that Mattel improperly accounted for \$17 million in royalty payments. What entry does the lawsuit allege that Mattel failed to make in 1994?
5. What does the article have to say about the quality of Mattel's earnings for 1994.

Answers

1. E; True
2. E; False
3. E; True
4. M; False
5. M; True

- | | | | |
|-----|---------|-----|--|
| 6. | M;True | 41. | M;(b) |
| 7. | M;False | 42. | M;(c) |
| 8. | M;False | 43. | M;(b) |
| 9. | M;True | 44. | M;(c) |
| 10. | M;False | 45. | M;(b) |
| 11. | M;True | 46. | M;(a) |
| 12. | E;True | 47. | M;(c) |
| 13. | E;False | 48. | M;(c) |
| 14. | M;True | 49. | M;(d) |
| 15. | M;True | 50. | M;(b) |
| 16. | M;False | 51. | M;(d) |
| 17. | M;True | 52. | M;(a) |
| 18. | M;False | 53. | M;(a) |
| 19. | M;True | 54. | M;(d) |
| 20. | M;False | 55. | M;(b) |
| 21. | M;True | 56. | M;(a) |
| 22. | M;True | 57. | M;(c) |
| 23. | E;(a) | 58. | M;(d) |
| 24. | E;(c) | 59. | M;(b) |
| 25. | M;(b) | 60. | M;(b) |
| 26. | M;(b) | 61. | M;(a) |
| 27. | M;(c) | 62. | M;(c) |
| 28. | M;(d) | 63. | M;(c) |
| 29. | M;(d) | 64. | M;(b) |
| 30. | M;(c) | 65. | M;(b) |
| 31. | M;(d) | 66. | M;(a) |
| 32. | M;(c) | 67. | M;(a) |
| 33. | D;(b) | | |
| 34. | D;(a) | 68. | Solution: |
| 35. | M;(c) | 1. | Accounting income is being used to determine management incentives and stock option awards. Also, royalty payments to Disney are probably based on sales of toys based on Disney characters. |
| 36. | M;(a) | 2. | Mattel may have misled analysts and investors about their earnings. The analysts and investors relied on the financial information when valuing the firm. |
| 37. | M;(b) | 3. | The article states that Mattel is alleged to have inflated sales, which |
| 38. | M;(c) | | |
| 39. | M;(d) | | |
| 40. | M;(b) | | |

implies that the revenue was not earned or not realizable at the time that it was recognized. The main issue for matching is that royalty costs were not recognized in the appropriate period. In other words, they were not matched against revenue recognized.

4.	Royalty expense	\$17	
	Accrued royalty expense		\$17

5. The article suggests that the quality was low. Revenue may have been overstated and expense may have been understated.