LM10 · FINANCIAL STATEMENT ANALYSIS · CFA LEVEL I

Financial Reporting Quality

Judging whether the numbers on the page reflect the economic reality of the business

What This Reading Covers

This module teaches you to evaluate the **quality** of financial statements — not just whether they comply with GAAP/IFRS, but whether they are **decision-useful** and whether the underlying earnings are **sustainable**. You will learn to place companies on a quality spectrum, recognize the motivations and conditions that lead to low-quality reports, identify warning signs in specific accounts, and apply analyst tools to detect manipulation.

Learning Outcome Statements

LOS a	Compare financial reporting quality with the quality of reported results (including earnings, cash flow, and balance sheet items)
LOS b	Describe a spectrum for assessing financial reporting quality
LOS c	Explain the difference between conservative and aggressive accounting
LOS d	Describe motivations that might cause management to issue financial reports that are not of high quality
LOS e	Describe conditions that are conducive to issuing low-quality, or even fraudulent, financial reports
LOS f	Describe mechanisms that discipline financial reporting quality and the potential limitations of those mechanisms
LOS g	Describe presentation choices, including non-GAAP measures, that could be used to influence an analyst's opinion
LOS h	Describe accounting methods (choices and estimates) that could be used to manage earnings, cash flow, and balance sheet items
LOS i	Describe accounting warning signs and methods for detecting manipulation of information in financial reports

Exam Tip: LM10 is heavily conceptual — expect questions that distinguish **reporting quality** from **earnings quality**, place a fact pattern on the quality **spectrum**, and identify which motivation, condition, or warning sign best matches a scenario. Memorize the fraud-triangle (motivation / opportunity / rationalization) and the 6-tier spectrum.

LOS A · TWO DIMENSIONS OF QUALITY

Financial Reporting Quality vs. Earnings Quality

TWO INDEPENDENT DIMENSIONS

FINANCIAL REPORTING QUALITY

= quality of the INFORMATION

Do the statements follow GAAP/IFRS?

Are they decision-useful?

Are they relevant & faithfully representative of economic reality?

Complete · Neutral · Error-free

High FRQ is a REQUIREMENT before you can even judge earnings quality

EARNINGS (RESULTS) QUALITY

= quality of the UNDERLYING PERFORMANCE

Are earnings sustainable?

Do they represent an adequate return on invested capital?

Do they come from genuine core operations (cash-backed)?

Persistent · Sustainable · Recurring

Key Distinction

REPORTING QUALITY

How well the statements convey information. High-quality reporting is compliant with GAAP/IFRS *and* decision-useful — relevant and a faithful representation of the company's economic reality.

Faithful representation means complete, neutral (unbiased), and free from error.

EARNINGS QUALITY

How sustainable the reported results are. High-quality earnings are persistent, come from genuine core operations, and represent an adequate return on invested capital.

Low earnings quality can stem from one-time items, low or negative ROIC, or from earnings that will not recur.

The Dependency Rule

A firm can have **high reporting quality but low earnings quality** (e.g., truthfully reporting that the business is failing). But if a firm has **low reporting quality**, you cannot reliably judge earnings quality at all — the numbers themselves are untrustworthy.

Exam Tip: The CFA exam tests this distinction directly. Reporting quality = how it's *reported*. Earnings quality = how *sustainable* the numbers are. Low reporting quality makes earnings-quality assessment impossible.

LOS B · THE QUALITY SPECTRUM

The Quality Spectrum: High to Low

Financial reporting can be ranked from highest to lowest quality along a combined spectrum that considers **both** reporting quality and earnings quality. The six tiers below descend from fully compliant and sustainable to outright fraud.

FINANCIAL REPORTING QUALITY SPECTRUM

TIER 1 — HIGHEST QUALITY
GAAP-compliant + Decision-useful + Earnings are SUSTAINABLE and adequate

TIER 2 — GAAP + DECISION-USEFUL, but earnings UNSUSTAINABLE
Reporting is good; business results are weak or non-recurring

TIER 3 — GAAP-COMPLIANT but with BIASED CHOICES
Aggressive or conservative choices (e.g., aggressive revenue recognition)

TIER 4 — GAAP-COMPLIANT but with EARNINGS MANAGEMENT
Actively increasing, decreasing, or smoothing earnings ("cookie-jar" reserves)

TIER 5 — NON-GAAP (numbers reflect real activities)
Not compliant, but the activities reported actually occurred

TIER 6 — LOWEST QUALITY / FRAUD
Non-compliant AND fictitious — fabricated or fraudulent numbers

Quality decreases ↓

What Separates Each Tier

Tier 1	**Both** dimensions are high — the gold standard for investors.
Tier 2	Reporting is fine; **earnings** are just not sustainable or adequate (declining business, one-time gains).
Tier 3	Still GAAP/IFRS-compliant, but management has picked **biased estimates and methods** that push earnings in a direction.
Tier 4	GAAP-compliant, but **earnings management** — deliberately smoothing or hitting targets (cookie-jar reserves).
Tier 5	**Not GAAP-compliant**, but the activities actually occurred. Still untrustworthy.
Tier 6	**Fraud.** Fictitious activities, fabricated revenue, fake customers.

Exam Tip: On the exam, a case like "company truthfully discloses declining margins and lower revenue" = Tier 2 (*high reporting quality, low earnings quality*). Don't confuse "bad results" with "bad reports."

LOS C · BIAS IS BIAS, REGARDLESS OF DIRECTION

Conservative vs. Aggressive Accounting

Both conservative and aggressive accounting are **biased** — they deviate from neutral presentation. Neither is inherently higher quality; the goal is *neutral (unbiased)* reporting.

Aggressive Accounting

Biased choices that **increase reported earnings** or improve financial position in the current period.

Typical consequence: decreases earnings in future periods (the bill eventually comes due).

Examples:

- Aggressive revenue recognition (FOB shipping point, channel stuffing, bill-and-hold)
- Capitalizing costs normally expensed
- Extending useful lives to reduce depreciation
- Under-reserving for warranty or bad debt

Conservative Accounting

Biased choices that **decrease reported earnings** or financial position in the current period.

Typical consequence: increases earnings in future periods.

Examples:

- Conservative revenue recognition (FOB destination)
- Expensing R&D immediately
- Using shorter useful lives / higher depreciation
- Over-reserving for contingencies (cookie jar)

Earnings Smoothing = Both Biases Combined

A manager may use **conservative** accounting when earnings are above targets (to bank earnings for later) and **aggressive** accounting when earnings are below targets. The result is artificially smooth reported earnings — *less volatile than true performance*. This is sometimes called putting earnings in the "cookie jar" for later.

Why Neither Is "Good"

Conservatism is often considered safer, but it still violates neutrality — a core quality of faithful representation. Users of biased financials cannot properly assess:

1. Trend and persistence of earnings
2. True return on invested capital
3. Comparability with peers using unbiased methods

That said, GAAP itself imposes some conservatism (e.g., higher standards of verification for revenue than for expenses), and conservative bias can reduce litigation risk and protect creditors.

Exam Tip: Trap: "Conservative accounting improves reporting quality." FALSE. Conservative bias deviates from neutrality just as aggressive bias does. The target is **neutral** presentation.

QUIZ 1 · CHECKPOINT

Test Your Understanding: FRQ, Earnings Quality & Spectrum

Q1. A company reports GAAP-compliant financial statements that faithfully represent the business. However, its earnings come almost entirely from a one-time asset sale. This company is best placed on the quality spectrum at:

Q2. Which statement about conservative accounting is *most* accurate?

Q3. Financial reporting quality is *most* accurately described as referring to:

Q4. Earnings smoothing is *best* described as:

LOS D · WHY MANAGERS MISREPORT

Motivations for Low-Quality Reporting

Managers typically do not wake up planning to misreport. Specific incentives and pressures push them toward biased or low-quality choices.

MARKET-FACING MOTIVATIONS

1. **Meet or exceed analyst expectations / EPS benchmarks** — missing a quarterly estimate can trigger a steep stock-price drop.
2. **Boost the stock price** — particularly around financing events, acquisitions paid in stock, or insider sales.
3. **Mask poor performance** — especially before refinancing or a capital raise.
4. **Gain credibility with customers and suppliers** — weakness can trigger tighter trade terms.

PERSONAL / CONTRACTUAL MOTIVATIONS

5. **Increase incentive compensation** — bonuses, stock options, and long-term incentive plans are tied to earnings targets.
6. **Enhance reputation / career prospects** — promotions depend on hitting numbers.
7. **Avoid debt-covenant violations** — especially in highly leveraged and unprofitable firms, where a breach could accelerate debt or block financing.

The Highest-Risk Profile

The combination most prone to low-quality reporting: **a highly leveraged and unprofitable company nearing a covenant threshold, with executive compensation tied heavily to short-term earnings.** Motivation is stacked from every side.

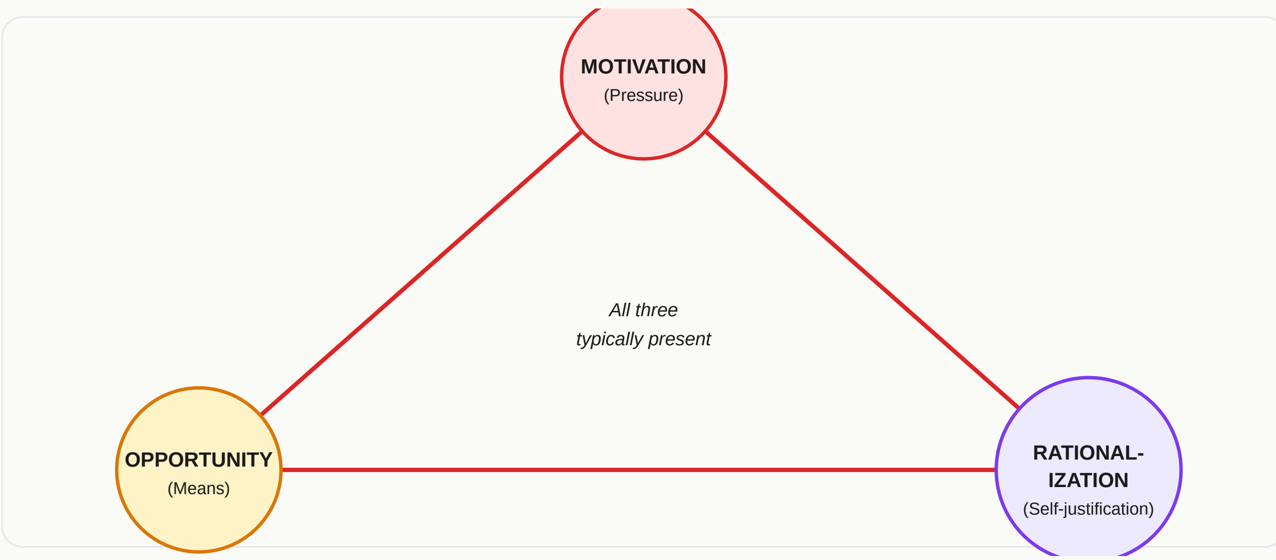
Exam Tip: "Analyst expectations" and "debt covenants" are the two motivations tested most often. Memorize them. On item sets, look for phrases like "the firm is approaching its minimum interest-coverage ratio" — that screams covenant-driven motivation.

LOS E · MOTIVATION + OPPORTUNITY + RATIONALIZATION

Conditions Conducive to Low-Quality Reporting

Three factors typically co-exist in cases of low-quality or fraudulent reporting — the classic "fraud triangle."

THE FRAUD TRIANGLE



The Three Legs

Motivation (Pressure)	The incentives covered in the previous step — hit EPS, protect compensation, avoid covenant breach, boost share price.
Opportunity	The *means* to carry it out without getting caught (see below).
Rationalization	A self-justifying narrative — *"I'll fix it next quarter," "Everyone does this," "It's for the good of the company."*

What Creates "Opportunity"?

1. **Weak internal controls** — easy to override journal entries, shift cutoffs, or book entries without review.
2. **Inadequate board / audit-committee oversight** — no one is independently challenging management's choices.
3. **Wide range of acceptable accounting treatments** — GAAP/IFRS permit many choices for estimates (useful lives, allowances, fair values).

4. **Inconsequential penalties** for accounting fraud in the jurisdiction — low expected cost of getting caught.

Rationalization in the Wild

Common rationalizations include: *"We're just managing earnings until the deal closes"*, *"The true economics justify this treatment"*, *"Our auditors signed off"*, *"Competitors do the same thing."* Investigators listen for these phrases — they often accompany fraud.

Exam Tip: Memorize the triangle: **Motivation · Opportunity · Rationalization**. Exam questions commonly ask which of three listed items does *not* fit. Weak internal controls = opportunity (not motivation).

LOS F · WHAT DISCIPLINES REPORTING QUALITY

Mechanisms That Discipline Financial Reporting

Several forces constrain how far management can push low-quality reporting. None is perfect — each has limitations.

MECHANISM	HOW IT WORKS	LIMITATION
Market forces	Companies that want low cost of capital must build credibility. Poor reporting → higher required returns from investors → higher financing cost.	Works slowly and imperfectly; market can be fooled for long periods.
Auditors	External audit provides reasonable assurance that statements are fairly presented under GAAP/IFRS. An unqualified opinion is a baseline signal.	Auditors are *selected and paid by the firm being audited.* A clean opinion does **not** guarantee no fraud.
Regulators (e.g., SEC)	Enforce GAAP/IFRS, bring enforcement actions, require restatements. SEC reviews 10-Ks and 10-Qs, can impose penalties and bar executives.	Reactive — enforcement often follows, not prevents, the damage. Resource-constrained.
Board & Audit Committee	Independent directors oversee management, interact directly with external auditors, approve accounting policies.	Only effective when genuinely independent and knowledgeable. Captured boards fail this role.
Contractual provisions	Debt covenants, executive claw-backs, and comp provisions tailored to penalize misreporting.	Only bite after detection; may themselves create motivation for misreporting.

The Audit-Opinion Limitation

A "clean" (unqualified) audit opinion only means the statements have been fairly reported *in accordance with GAAP* — it does **not** guarantee the absence of fraud or of biased-but-GAAP-compliant choices. Auditors provide *reasonable* — not absolute — assurance.

Exam Tip: Common trap: "An unqualified audit opinion guarantees that a company has not engaged in fraud." FALSE. It provides reasonable assurance of fair presentation under GAAP — nothing more.

LOS G · PRESENTATION & NON-GAAP MEASURES

Non-GAAP Measures & Presentation Choices

Firms frequently present **non-GAAP** (sometimes called "pro forma" or "adjusted") metrics alongside the audited statements. Analysts must scrutinize these — they are often designed to make performance look better.

Common Adjustments to "Adjusted EBITDA"

Companies often construct their own version of EBITDA by excluding:

- Rental payments for operating leases
- Equity-based (stock) compensation (framed as non-cash)
- Acquisition-related charges
- Impairment charges for goodwill or intangibles
- Impairment charges for long-lived assets
- Litigation costs
- Gains/losses on debt extinguishment
- Other "one-time" or "non-recurring" items

Regulatory Requirements

US SEC — NON-GAAP RULES

- Display the most comparable **GAAP measure with equal prominence**
- Explain why the non-GAAP measure is useful
- Reconcile non-GAAP to the comparable GAAP figure
- Disclose other uses of the measure
- Must include items likely to recur, even if labeled "nonrecurring"

IFRS — NON-IFRS MEASURES

- **Define and explain** the relevance of non-IFRS measures
- Reconcile to the most comparable IFRS measure

Analyst Red Flags with Non-GAAP

Watch for: (1) the same "non-recurring" charges appearing every period, (2) stock-based comp excluded (it is a real economic cost), (3) "adjusted" numbers emphasized more than GAAP figures in earnings releases, (4) adjustments that reconcile a GAAP loss into a non-GAAP "profit."

Exam Tip: If a charge labeled "non-recurring" keeps recurring, it's recurring — flag the non-GAAP measure as unreliable.

LOS H & I · CHOICES, ESTIMATES & WARNING SIGNS

Accounting Choices & Warning Signs

Revenue Recognition

TECHNIQUE	EFFECT
Shipping terms (FOB shipping point vs. destination)	FOB shipping point recognizes revenue earlier — more aggressive.
Channel stuffing	Shipping extra goods to distributors to pull in future-period revenue. Watch for inventory build at channel partners and rising receivables.
Bill-and-hold	Customer is invoiced but goods stay in the firm's warehouse. Fictitious bill-and-hold inflates current revenue.
Related-party sales	Selling to an entity controlled by management at inflated prices.
Long-term contract estimates	Percentage-of-completion estimates give management discretion over timing of revenue.
Barter & rebates	Complex arrangements with estimation risk, often lacking transparency.

Estimates & Reserves

Allowance for Doubtful Accounts

Under-reserving → higher net receivables and higher NI. Watch for *declining* allowance as % of AR while receivables grow.

Warranty Reserves

Lowering warranty reserves increases current earnings; raising reserves decreases them.

Deferred Tax Valuation Allowance

Reducing the valuation allowance on DTAs increases net DTA and NI; raising it reduces them.

Goodwill Impairment

Delaying or ignoring impairment inflates assets and NI. Goodwill is not amortized, only tested.

Depreciation, Capitalization & Inventory

CHOICE	AGGRESSIVE DIRECTION	EARNINGS EFFECT (CURRENT)

Useful life	Extend	Lower depreciation → higher NI
Salvage value	Increase	Lower depreciation → higher NI
Capitalize vs. expense	Capitalize	Higher NI + CFO increases (expense would have hit CFO; capital cost hits CFI)
Inventory method (rising prices)	FIFO	Lower COGS → higher NI vs. weighted avg.
LIFO liquidation (US GAAP, rising prices)	Draw down inventory	Old low-cost layers → artificially low COGS → high margin

Classic Warning Signs Checklist

- Revenue growth out of line with peers or with AR/asset growth
- Receivables turnover *declining* over multiple periods (revenue growing but not being collected)
- Inventory turnover *declining* (possible obsolescence or channel stuffing)
- CFO persistently less than net income, or declining CFO/NI ratio
- Fourth-quarter earnings pattern out of sync with the industry's seasonality
- "Non-recurring" charges that recur every year
- Gross or operating margins materially higher than peers
- Related-party transactions
- Non-operating items or one-time gains included in revenue
- Depreciation lives / salvage values out of line with peers
- Management fixation on non-GAAP metrics and minimal disclosure
- Growth via many acquisitions (complicates comparability and depreciation)

Exam Tip: Two patterns are tested heavily: (1) **CFO < NI** persistently (earnings not cash-backed) and (2) **AR growing faster than revenue** (low-quality revenue, possible channel stuffing).

LOS H · CASH-FLOW-SPECIFIC MANIPULATION

How Cash Flow Can Be Manipulated

Because analysts trust CFO more than net income, managers have an incentive to inflate CFO. Several techniques can shift cash flows *between classifications* without creating new cash.

TECHNIQUE	MECHANISM	EFFECT ON CFO
Capitalize operating costs	An outflow that would have been CFO becomes CFI (purchase of an asset)	CFO ↑ · CFI ↓
Stretch payables	Delay payments to suppliers until after period-end	CFO ↑ in current period, ↓ next period
Securitize / factor receivables	Sell AR for cash, classified as CFO	CFO ↑ (one-time)
Capitalize interest	Interest that would have reduced CFO sits in fixed assets (CFI outflow)	CFO ↑ · CFI ↓ · future depreciation ↑
Classify interest/dividends flexibly (IFRS)	Interest paid as CFF instead of CFO; dividends received as CFO instead of CFI	CFO can be optimized via choice
Off-balance-sheet financing	Operating leases, special purpose entities — keep debt and related cash flows off statements	CFO appears larger relative to reported debt

Analyst Rule of Thumb

Recall Scotland: when a company consistently reports strong NI but **CFO persistently less than NI**, question the quality of earnings. If the gap is growing — or if CFO improves mainly via stretching payables and capitalizing expenses — quality is likely deteriorating.

Exam Tip: Under IFRS, the *classification choice* for interest and dividends is itself a quality issue — a firm that moves interest paid from CFO to CFF will show "higher" CFO without any change in economics.

LOS I · QUANTITATIVE TOOLS FOR DETECTION

Analyst Tools to Detect Low Quality

Analysts use quantitative screens to flag companies with likely earnings manipulation or financial distress. These are early-warning indicators — not proof — but they direct further investigation.

Tool 1 — Accruals Ratio

Net income is the sum of cash earnings and accruals. When accruals dominate, earnings are considered **low quality** — less cash-backed, more dependent on estimates.

$$AggregateAccruals = NetIncome - CashFlowfromOperations$$

$$AccrualsRatio = (NI - \text{CFO}) / AverageTotalAssets$$

Interpretation: a **higher** accruals ratio → lower earnings quality. A **negative** accruals ratio (CFO > NI) is generally a good sign of cash-backed earnings.

Tool 2 — Beneish M-Score

The **Beneish M-Score** is a probabilistic model using 8 variables to estimate the likelihood of earnings manipulation. Components include:

- Days sales in receivables index (DSRI)
- Gross margin index (GMI)
- Asset quality index (AQI)
- Sales growth index (SGI)
- Depreciation index (DEPI)
- SG&A index (SGAI)
- Leverage index (LVGI)
- Total accruals to total assets (TATA)

Rule of thumb: An M-Score greater than roughly **−1.78** suggests a higher probability of earnings manipulation. The higher the score, the higher the red-flag.

Tool 3 — Altman Z-Score (Bankruptcy Prediction)

Altman's **Z-Score** combines five financial ratios into a single distress indicator, originally developed for manufacturing firms. Distress risk is one dimension of earnings-quality concern.

Z > 3.0	Safe zone — low distress risk
1.8 < Z < 3.0	Grey zone — caution

Z < 1.8	Distress zone — elevated bankruptcy risk

Inputs include working capital/assets, retained earnings/assets, EBIT/assets, market value of equity/total liabilities, and sales/assets.

Tool 4 — Cash Flow Quality Checks & Peer Comparison

1. **CFO / NI ratio:** persistently < 1 or declining → earnings not cash-backed.
2. **Peer comparison:** compare gross margin, turnover ratios, accruals, useful lives, and DSO across direct peers. Outliers deserve scrutiny.
3. **Trend analysis:** deterioration of quality metrics over consecutive periods is more telling than a single year.

Exam Tip: For the exam, memorize **Accruals Ratio = (NI − CFO) / Avg Total Assets** and know that **higher = lower quality**. Know Beneish (earnings-manipulation screen) and Altman Z (bankruptcy screen) by name and purpose.

WORKED EXAMPLE · APPLYING THE TOOLS

Putting It All Together

WORKED EXAMPLE

Scenario. Gamma Corp is a mid-cap consumer-products company. Selected data for the most recent year:

METRIC	FY24	FY23	FY22
Revenue growth	18%	6%	5%
Accounts receivable growth	42%	8%	5%
Receivables turnover	5.2×	6.9×	7.1×
Net income ($M)	120	98	90
CFO ($M)	45	90	95
Avg total assets ($M)	1,000	900	850
Useful life on PP&E	15 yrs	12 yrs	12 yrs
Non-recurring legal charges (disclosed)	Every year since FY20		

Task: Evaluate earnings quality and identify at least four warning signs.

SOLUTION

Step 1 — Compute the Accruals Ratio (FY24):

```
Accruals Ratio = (NI - \text{CFO}) / Avg TA = (120 - 45) / 1,000 =
75 / 1,000 = \mathbf{+7.5%}
```

Prior year: (98 − 90)/900 = +0.9%. The accruals ratio has jumped from essentially neutral to materially positive — a sharp deterioration in earnings quality.

Step 2 — Cash-Flow-to-NI:

$$\text{CFO}/NI = 45/120 = \mathbf{0.38}\times(down from 0.92\times\ and 1.06\times)$$

Earnings are no longer cash-backed. Classic warning.

Step 3 — Warning Signs Identified:

1. **Revenue growth (18%) dwarfs prior trend (5–6%)** — possible channel stuffing or aggressive revenue recognition.
2. **AR growing much faster than revenue** (42% vs 18%), and **receivables turnover declining** 7.1× → 5.2×. Revenue appears not to be collectible in cash.
3. **CFO < NI by a wide margin** and the accruals ratio has spiked.
4. **Useful life extended** from 12 to 15 years — lowers depreciation, boosts NI without economic change.
5. **"Non-recurring" legal charges recur every year** — mislabeled to dress up non-GAAP earnings.

Conclusion: Gamma Corp shows multiple, mutually reinforcing signs of aggressive accounting and low earnings quality. It likely sits at **Tier 3 or Tier 4** of the quality spectrum. Apply a Beneish M-Score and compare to peers before relying on the reported financials.

QUIZ 2 · CHECKPOINT

Test Your Understanding: Motivations, Conditions & Warning Signs

Q5. Which of the following is *least likely* a condition that provides management with the *opportunity* to issue low-quality financial reports?

Q6. A firm's accounts receivable are growing faster than its revenue, and receivables turnover has been falling for three consecutive years. This is *most* consistent with:

Q7. A company's CFO has been persistently less than net income for three years, and the gap is widening. An analyst should conclude that:

Q8. Which of the following is *most likely* a mechanism that disciplines financial reporting quality?

QUIZ 3 · FINAL CHECKPOINT

Test Your Understanding: Integration

Q9. A company extends the estimated useful life of its manufacturing equipment from 10 years to 15 years. Assuming all else equal, the *immediate* effect on current-period reported results is:

Q10. The accruals ratio for a firm is computed as +9% of average total assets, compared with a peer median of +1%. The interpretation is that the firm's earnings quality is *most likely*:

Q11. The Beneish M-Score is *best* described as a tool to:

Q12. A firm capitalizes a cost that its peers expense. Holding all else constant, in the current period this choice will *most likely*:

MODULE COMPLETE

Your Scorecard

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LM10 Key Takeaways — Exam-Ready Cheat Sheet

Two Kinds of Quality

1. **Reporting quality** = quality of the *information* (GAAP-compliant + decision-useful, relevant, faithful).
2. **Earnings (results) quality** = quality of the *performance* (sustainable, adequate ROIC, cash-backed).
3. Low reporting quality makes earnings-quality assessment **impossible**.

The Six-Tier Spectrum

4. **T1** GAAP + DU + sustainable · **T2** GAAP + DU, not sustainable · **T3** GAAP but biased · **T4** GAAP + earnings mgmt · **T5** Non-GAAP (real activities) · **T6** Fraud/fictitious.

Conservative vs. Aggressive

5. Both are biased — only **neutral** presentation is high quality. Aggressive ↑ current earnings (and ↓ future); conservative ↓ current (and ↑ future). Smoothing uses both across periods.

Fraud Triangle

6. **Motivation** (EPS, comp, covenants, stock price) + **Opportunity** (weak controls, weak board, flexible GAAP, low penalties) + **Rationalization**.

Disciplining Mechanisms

7 Market forces, auditors, regulators (SEC), board/audit committee, contract provisions. *None guarantees no fraud* — an unqualified audit = reasonable assurance only.

Warning Signs

8 **Revenue:** channel stuffing, bill-and-hold, FOB shipping point, related-party, non-operating items in revenue.

9 **Balance-sheet:** capitalizing normally-expensed costs, extended useful lives, under-reserved allowances, delayed goodwill impairment.

10 **Cash flow:** CFO < NI persistently, stretching payables, capitalizing interest, off-balance-sheet financing.

11 **Presentation:** recurring "non-recurring" items, non-GAAP emphasis, minimal disclosure, growth via many acquisitions.

Analyst Tools

12 **Accruals Ratio = (NI − CFO)/Avg TA** — higher = lower quality. **Beneish M-Score** (8 variables) — earnings-manipulation probability. **Altman Z-Score** — bankruptcy prediction. Plus peer comparison and CFO/NI trend.

Last-Minute Exam Checklist

Reporting vs earnings quality: information vs sustainability

Spectrum: T1 highest → T6 fraud (GAAP → biased → mgmt → non-GAAP → fictitious)

Neutral > conservative = aggressive (all bias lowers quality)

Fraud triangle: Motivation · Opportunity · Rationalization

Top motivations: EPS targets, comp, covenants, stock price

Opportunity factors: weak controls, weak board, GAAP range, low penalties

Classic signals: AR > revenue growth · CFO < NI · useful life extended · recurring "non-recurring" charges

Accruals Ratio: (NI − CFO)/Avg TA — higher = lower quality

Beneish M-Score: manipulation · **Altman Z:** bankruptcy

Step 1 of 16