1. Read the following article carefully and answer the questions.

"Despite repeated demonstrations of the truism that no single measure encapsulates all of a company's pertinent financial traits, investors continue to search for the 'silver bullet.' If a company's value is not a direct function of its net income, they tell themselves, the problem must be that net income is too greatly affected by incidental factors such as tax rates and financial leverage. The answer must be to move up the income statement to a measure that pulls companies on a more even plane with one another. As Merrill Lynch investment strategist R. Bernstein points out, operating earnings tend to be more stable than reported earnings. EBIT tends to be more stable than Operating earnings, and EBITDA tends to be more stable than EBIT. Companies welcome analytical migration toward less variable measures of performance, because investors reward stability with high price-earnings multiples. The trend of moving up the income statement reached its logical conclusion during the technology stock boom of the late 1990s. Investors latched onto the highest, most stable figure of all by valuing stocks on price-sales ratios. (To obscure what was going on, some companies actually reported to investors their earnings before expenses, or EBE.)

Strategist Bernstein found that by attempting to filter out the volatility inherent in companies' earnings, investors reduced the effectiveness of their stock selection. In a study spanning the period 1986 to July 2001, he compared the performance of portfolios of stocks based on low ratios of price to earnings with alternative portfolios of stocks priced at low multiples of EBITDA, cash flow, book value, and sales. The good old-fashioned low P/E criterion produced the highest average return (16.7%) of any of the strategies. Stocks chosen on the basis of low total enterprise value to EBITDA produced the lowest average return, 12.3%. Adjusted for risk, as well, investors achieved far better results by relying on the bottom line, net income, instead of moving up the income statement to EBITDA. Bernstein's findings reinforce the message that instead of seeking an alternative to net income that summarizes corporate performance in its entirety, analysts of financial statements should examine a variety of measures to derive maximum insight."

(i) Do you agree to the statement, "If a company's value is not a direct function of its net income, they tell themselves, the problem must be that net income is too greatly affected by incidental factors such as tax rates and financial leverage." Explain why or why not. [20 points]

(ii) Comment on the statement, "The trend of moving up the income statement reached its logical conclusion during the technology stock boom of the late 1990s. Investors latched onto the highest, most stable figure of all by valuing stocks on price-sales ratios." [20 points]

(iii) Strategist Bernstein found that "Stocks chosen on the basis of low total enterprise value to EBITDA produced the lowest average return, 12.3%." What does it mean by "enterprise value?" What are the limitations of financial reports in communicating the true value of high-tech companies in the era of knowledge economy? [20 points]

2. Discuss the truthfulness of the following two statements.

(i) The primary goal in financial reporting is the dissemination of financial statements that accurately measure the profitability and financial condition of a company. [20 points]

(ii) The purpose of financial reporting is to obtain cheap capital. [20 points]