

Chapter 2

Introduction to Financial Statements and Other Financial Reporting Topics

TO THE NET

1. Carol and Lawrence Zicklin Center for Business Ethics Research.

Mission Statement

Our mission is to sponsor and disseminate leading edge research on critical topics of business ethics.

Each student will select an academic journal and an article from that journal.

2. Each student selects a company to summarize that company's code of conduct.
3. Each student selects a company to summarize a corporate scandal.
4.
 - a. The IASB structure has the following main features: the IASC Foundation is an independent organization having two main bodies, the Trustees and the IASB, as well as a Standards Advisory Council and the International Financial Reporting Interpretations Committee. The IASC Foundation Trustees appoint the IASB members, exercise oversight and raise the funds needed, but the IASB has sole responsibility for setting accounting standards.
 - b. Parts of the news release 2-27-06 was used for this example answer: "The U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) today published a Memorandum of Understanding (MOU) that reaffirms the boards' shared objective of developing high quality, common accounting standards for use in the world's capital markets. Both boards believe that a common set of high quality accounting standards will enhance the consistency, comparability and efficiency of financial statements enabling global markets to move with less function.
 - c. The adoption is by country summarized by domestic listed companies, and domestic unlisted companies. For example, the country Dominican Republic domestic listed companies, IFRSs required for all. For unlisted companies, IFRSs required for all.
 - d. Selected IFRS 8
Reported here is a small part of the summary "IFRS 8 required an entity to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments that meet specified criteria." This is an open-ended question. Each individual will select a recent IFRS.

5. COSO was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private sector initiative which studied the casual factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions.

Five professional associations that sponsored COSO:

1. American Accounting Association
2. American Institute of Certified Public Accountants
3. Financial Executives International
4. The Institute of Internal Auditors
5. Institute of Management Accountants

6. a. Ford Motor Company

Automotive sales and financial services revenues are presented separately.

- b. Dow Chemical Company

The companies are presented by summing the numbers together.

7. The five highest officers are listed. Compensation consists of salary, bonus, stock awards, option awards, non-equity incentive plans, changes in pension value and nonqualified deferred compensation earnings, and all other.

8. Report of Independent Registered Public Accounting Firm

The Bemis Company report combines an opinion and internal control over financial reporting.

Exhibit 2-5 presents the audit opinion separately.

Exhibit 2-6 presents the report on internal controls separately.

QUESTIONS

- 2- 1. a. Unqualified opinion with explanatory paragraph
 b. Unqualified opinion with explanatory paragraph
 c. Unqualified opinion
 d. Adverse opinion
 e. Qualified opinion

- 2- 2. The responsibility for the preparation and integrity of financial statements rests with management. The auditor simply examines them for fairness, conformity with GAAP, and consistency.

- 2- 3. The basic purpose of the integrated disclosure system is to achieve uniformity between annual reports and SEC filings. It is hoped that this will improve the quality of disclosure and lighten the disclosure load for the companies reporting.

- 2- 4. The explanatory paragraphs explain important considerations that the reviewer of the financial statements should be aware of. An example would be a doubt as to going concern ability.

- 2- 5. A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an examination in accordance with generally accepted auditing standards.

- 2- 6. No. The accountant's report will indicate that they are not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles, and the report will indicate departures from generally accepted accounting principles. The accountant does not express an opinion on reviewed financial statements.

- 2- 7. The accountant does not express an opinion or any other form of assurance with a compilation.

- 2- 8. No. Some statements have not been audited, reviewed, or compiled. These statements are presented without being accompanied by an accountant's report.

2- 9. Balance Sheet

The purpose of a balance sheet is to show the financial position of an accounting entity as of a particular date.

Income Statement

The income statement summarizes the results of operations for an accounting period.

Statement of Cash Flows

The statement of cash flows details the inflows and outflows of cash during a specified period of time.

- 2-10. Notes to the financial statements increase the full disclosure of the statements by providing additional information on inventory and depreciation methods, subsequent events, contingent liabilities, etc.
- 2-11. Contingent liabilities are dependent on an occurrence or nonoccurrence to determine if payment will be necessary. Liabilities from lawsuits are dependent on the outcome of the cases; they therefore represent contingent liabilities.
- 2-12. a, c
- 2-13. A proxy is the solicitation sent to stockholders for the election of directors and for the approval of other corporation actions. The proxy represents the shareholder authorization regarding the casting of that shareholder's vote.
- 2-14. A summary annual report is a condensed annual report that omits much of the financial information included in a typical annual report.
- 2-15. The firm must include a set of fully audited statements and other required financial disclosures in the proxy materials sent to shareholders. The 10-K is also available to the public.
- 2-16. There is typically a substantial reduction in non-financial pages and financial pages. The greatest reduction in pages is usually in the financial pages.
- 2-17. Cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities
- 2-18. The income statement and the statement of cash flows. The income statement describes income between two balance sheet dates. The statement of cash flows describes cash flows between two balance sheet dates.

- 2-19. Assets, liabilities, and owners' equity
- 2-20. No. Cash dividends are paid with cash. This reduces the cash account and the retained earnings account.
- 2-21. Notes are an integral part of financial statements. A detailed review of footnotes is absolutely essential in order to understand the financial statements.
- 2-22. APB Opinion No. 22 requires disclosure of accounting policies as the first note to financial statements or just prior to the notes.
- 2-23. They are interchangeable terms referring to ideals of character and conduct. These ideals, in the form of codes of conduct, furnish criteria for distinguishing between right and wrong.
- 2-24. Law can be viewed as the minimum standard of ethics.
- 2-25. $\text{Assets} = \text{Liabilities} + \text{Stockholders' equity (capital)}$.
- 2-26. The scheme of the double-entry system revolves around the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

With double-entry, each transaction is recorded with the total dollar amount of the debits equal to the total dollar amount of the credits. Each transaction affects two or more asset, liability, or owners' equity accounts (including the temporary accounts).

- 2-27. a. Assets, liabilities, and stockholders' equity accounts are referred to as permanent accounts because the balances in these accounts carry forward to the next accounting period.
- b. Revenue, expense, gain, loss, and dividend accounts are not carried into the next period. These accounts are closed to Retained Earnings. They are referred to as temporary accounts.
- 2-28. Because the employee worked in the period just ended, the salary must be matched to that period's revenue whether or not cash was paid to the employee.
- 2-29. Because we follow the accrual basis of accounting, not all accounts are up to date at the end of the accounting period. These accounts need to be adjusted so that all revenues and expenses are recognized and the balance sheet accounts have a correct ending balance.

- 2-30. Companies use a number of special journals to improve record keeping efficiency that could not be obtained by using only the general journal.
- 2-31. The serious concerns were about the cost of adoption, the benefits of adoption compared to convergence, and whether IFRS were in fact as good as or better than U.S. GAAP.
- 2-32. Sole Proprietorship
- A sole proprietorship is a business entity owned by one person.
- Partnership
- A partnership is a business owned by two or more individuals.
- Corporation
- A corporation is a legal entity incorporated in a particular state. Ownership is evidenced by shares of stock.
- 2-33. Even an efficient market does not have access to “inside” information; therefore, the use of insider information could result in abnormal returns.
- 2-34. In an efficient market, the method of disclosure is not as important as whether or not the item is disclosed.
- 2-35. Abnormal returns could be achieved if the market does not have access to relevant information or if fraudulent information is provided.
- 2-36. With the purchase method the firm doing the acquiring records the identifiable assets and liabilities at fair value at the date of acquisition. The difference between the fair value of the identifiable assets and liabilities and the amount paid is recorded as goodwill (an asset).
- 2-37. Consolidated statements reflect an economic, rather than a legal, concept of the entity.
- 2-38. The financial statements of the parent and the subsidiary are consolidated for all majority-owned subsidiaries unless control is temporary or does not rest with the majority owner.
- 2-39. The SEC requires that a copy of the companies code of ethics be made available by filing an exhibit with its annual report, or by providing it on the company's Internet Web Site.

- 2-40. Treadway Commission is the popular name for the National Commission on Fraudulent Reporting, named after its first chairman, former SEC Commissioner James C. Treadway. The commission has issued a number of recommendations for the prevention of fraud in financial reports, ethics, and effective internal controls.
- 2-41. The Sarbanes-Oxley Act requires the auditor to present a report on the firm's internal controls. The Sarbanes-Oxley Act also requires a report of management on internal control over financial reporting.
- 2-42. Audit Report
Report on the firm's internal controls
- 2-43. A report of management on internal control over financial reporting.
- 2-44. Reasons why some private companies elect to follow the law follow:
1. Owners hope to sell the company or take it public
 2. Directors who sit on public company boards see the law's benefit
 3. Executives believe strong internal controls will improve efficiency
 4. Customers require strong internal controls
 5. Lenders are more likely to approve loans
- 2-45.
 1. The subsidiary's accounts are shown separately from the parent's.
 2. Present the parent's and subsidiary accounts summed.
- 2-46. Control can be gained by means other than obtaining majority stock ownership. The FASB recognizes a risk, rewards, decision-making ability and the primary beneficiary.
- 2-47. Some countries do not consolidate. Other countries use consolidation with different rules.
- 2-48. Filing deadline for Form 10-K follow:
1. Large accelerated filer (\$700 million or more market value) – 60 days
 2. Accelerated filer (\$75 million or more and less than \$700 million market value) – 75 days
 3. Non-accelerated filer (less than \$75 million market value) – 90 days
- 2-49. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) met jointly in Norwalk, Connecticut on September 18, 2002. They acknowledge their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting (this is known as the Norwalk Agreement).
- 2-50. They will likely eliminate U.S. GAAP

- 2-51. The American Accounting Association Committee on Financial Reporting Policy concluded that eliminating the reconciliation requirement was premature. Several of their points follow:
1. Material reconciling items exist between U.S. GAAP and IFRS and the reconciliation currently reflects information that participants in U.S. stock markets appear to impound to stock prices.
 2. Cross-country institutional differences will likely result in differences in the implementation of any single set of standards.
 3. Legal and institutional obstacles inhibit private litigation against foreign firms in the United States and the SEC rarely undertakes enforcement actions against cross-listed firms.
 4. Differential implementation of standards across countries and a differential enforcement efforts directed toward domestic and cross-listed firms creates differences in financial reporting even with converged standards.
 5. Harmonization appears to be occurring via the joint standard-setting activities of the FASB and the IASB; thus, special, statutory intervention by the SEC appears to be unnecessary.
- 2-52. Professor Ball noted these problems with implementing IFRS:
1. On the con side, a deep concern is that the differences in financial reporting quality that are inevitable among countries have been pushed down to the level of implementation, and now will be concealed by a veneer of uniformity.
 2. Despite increased globalization, most political and economic influences on financial reporting practice remain local.
 3. The fundamental reason for being skeptical about uniformity of implementation in practice is that the incentives of preparers and enforcers remain primarily local.
 4. Under its constitution, the IASB is a standard setter and does not have an enforcement mechanism for its standards.
 5. Over time the IASB risks becoming a politicized, polarized, bureaucratic on-style body.

PROBLEMS

PROBLEM 2-1

Cash			
Dec 6	2,500	Dec 10	500
Dec 14	3,000	Dec 17	6,000
Dec 24	1,200	Dec 28	700

Accounts Receivable			
Dec 2	4,000	Dec 24	1,200
Dec 21	900		

Land			
2.200 original cost		Dec 14	2,200

Equipment			
Dec 17	6,000		

Sales			
		Dec 2	4,000
		Dec 6	2,500

Office Salaries			
Dec 10	500		

Gain on Sale of Land			
		Dec 14	800

Services			
		Dec 21	900

Accounts Payable			
Dec 28	700		

PROBLEM 2-2

Cash			
July 15	500	July 1	10,000
		July 20	300
		July 24	400

Accounts Receivable			
July 8	3,000	July 15	500

Land			
July 1	10,000		

Accounts Payable			
July 20	300	July 12	600

Revenue			
		July 8	3,000

Repair Expense			
July 12	600		

Wages Expense			
July 24	400		

PROBLEM 2-3

Insurance Expense		Prepaid Insurance	
(1) December 31	600	July 1	1,200
			(1) December 31
			600
Supplies Expense		Supplies	
(2)	300	September 10	500
		(2)	300
Revenue		Unearned Revenue	
(3)	1,000		(3)
			1,000
Interest Expense		Interest Payable	
(4)	200		(4)
			200
Salaries Expense		Salaries Payable	
(5)	500		(5)
			500
Revenue		Accounts Receivable	
	(6)	(6)	400
	400		

PROBLEM 2-4

Prepaid Insurance		Insurance Expense	
(1)	640	May 1	960
		(1)	640
Supplies Expense		Supplies	
(2)	100	December 1	400
		(2)	100
Interest Receivable		Interest Income	
(3)	100		(3)
			100
Salaries Expense		Salaries Payable	
(4)	800		(4)
			800
Unearned Revenue		Revenue	
	(5)	(5)	600
	600		
Accounts Payable		Advertising Expense	
	(6)	(6)	400
	400		

PROBLEM 2-5

- a. 4 The balance sheet equation is defined as assets are equal to liabilities plus owners' equity.
- b. 1 Assets (\$40,000) = liabilities(?) + owners' equity (\$10,000).
- c. 3 Assets (\$100,000) = liabilities (\$40,000) + owners' equity(?)
- d. 3 Accounts receivable is a balance sheet account and therefore a permanent account.
- e. 3 Insurance expense is an income statement account and therefore a temporary account.
- f. 4 Expenses, assets, and dividends all have a normal balance of a debit.

PROBLEM 2-6

- a. 1 All-purpose statement is not a classification for an audit opinion.
- b. 1 An unqualified opinion usually has the highest degree of reliability.
- c. 5 The typical unqualified opinion has three paragraphs.
- d. 4 All of the above.
- e. 4 Two years of audited balance sheets and three years of audited statements of income and three years of statements of cash flows.
- f. 1 Lack of harmonization of international accounting standards is thought to have a negative effect on international trade of accounting practice and services.
- g. 2 The Internal Revenue Service deals with U.S. federal taxes.
- h. 2 Form 10-K is the annual financial report submitted to the Securities and Exchange Commission.

PROBLEM 2-7

- a. 3 Management has the primary responsibility for the financial statements
- b. 1 Unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity, in conformity with generally accepted accounting principles
- c. 3 A review consists principally of inquiries made to company personnel and analytical procedures applied to financial data
- d. 1 A twenty-year summary of operations need not be provided with a complete set of financial statements
- e. 1 Financial statements of legally separate entities may be issued to show financial position, income, and cash flow as they would appear if the companies were a single entity (consolidated)
- f. 5 The need to have standards different from the United States standards did not influence accounting standards locally

PROBLEM 2-8

	Permanent (P) or Temporary (T)	Normal Balance Dr. (Cr.)
Cash	P	Dr.
Accounts receivable	P	Dr.
Equipment	P	Dr.
Accounts payable	P	Cr.
Common stock	P	Cr.
Sales	T	Cr.
Purchases	T	Dr.
Rent expense	T	Dr.
Utility expense	T	Dr.
Selling expenses	T	Dr.

PROBLEM 2-9

- c 1
- d 2
- b 3
- a 4

PROBLEM 2-10

- c 1
- b 2
- a 3
- d 4

CASES

CASE 2-1 THE CEO RETIRES

Teaching Note: The CEO Retires (Teaching note prepared by the American Accounting Association)

PURPOSE: This case is meant to illustrate that the accounting choices available can be used by management to manipulate the reported financial results of the company.

CONTENT: The CEO of a company is entering the last year of his employment. For reasons of enhanced reputation, maximum compensation in his final year, and maximum compensation through the years via his pension, he has the incentive to manipulate the financial results of the company. Since this is his last year with the company, any long-term effects of the decisions he may make are not considered relevant. Furthermore, there are numerous directions the CEO can take: changing accounting estimates, deferring investing decisions, or changing accounting methods.

After consideration of a variety of alternatives, the CEO meets with the CFO to get his response to the CEO's proposed options.

Decision Model

a. Determine the Facts

Work through the case, identifying essential facts, especially those included in the contents section above.

Known facts should be listed first; then determine what one would want to know if possible. NOTE: Make the point to students that we never have all the facts; decisions are almost always made on incomplete information.

b. Define the Ethical Issues

- (1) List all stakeholders - be sure that the class is thorough in this step -- the ethical issues will most likely arise out of conflicting interests between and among the stakeholders.

the CEO, Dan Murphy

the CFO, Mike Harrington

the other members of top management

the members of the Board of Directors

the company's auditors

the company's employees (i.e., if inventory builds, it may lead to later layoffs; a lack of repair work may create dangers in the workplace)

the company's customers (i.e., if inventory builds, it may lead to obsolescence; lack of repair work may lead to product quality problems)

(2) List the ethical issues

The CEO's compensation	vs.	The integrity of the company's financial statements
The CFO's loyalty to his superior	vs.	The CFO's responsibility to his job
The CFO's loyalty to his superior	vs.	The CFO's responsibility to protect the interests of the company and its employees
Top management's responsibility to represent the interests of the shareholders	vs.	Each individual's desire for promotion and advancement
The Board of Director's duty to provide oversight on the behalf of the shareholders	vs.	Rewarding the CEO for a job well done
The auditor's duty to ensure that the financial statements present fairly the condition of the company	vs.	The auditor's desire to remain engaged a the auditor of the company

(This list can be extended, but you should be sure that these issues are identified)

c. Identify Major Principles, Rules, and Values

(Here you will repeat some of the above, e.g. integrity, but you will translate others into ethical language, e.g., fairness, obligation, rights)

Integrity (of the CEO and of the financial statements)

Equity

Fairness

Credibility

Protection of the business

d. Specify the Alternatives

Identify major options: encourage creative solutions that may be closer to win-win if possible.

The CFO could support a favorable plan for the CEO

The CFO could object to the proposals and refuse to sign off on them

The CFO could object to the proposals and threaten to go to the Board if the CEO persists

The CFO could communicate his concerns to the outside auditors

Note: At this point, or even earlier, some students will have begun to take a position. The instructor should be aware of these positions and challenge students to be open to questioning their position, as well as to be open to similar questioning by others. You may want to return to this "position taking" in the discussion over Step (g), Make Your decision.

e. Compare Norms, Principles, and Values with the Various Alternatives

See how many of the class members will move to a decision at this point, based on the force or strength of a norm or principle. In some cases, a principle is so strong or the harm so egregious that some will decide now.

For example, the concern for integrity of the financial statements may lead to strong resistance by the CFO to the CEO's proposals.

Regardless of whether a decision is reached, work through Steps f and g as if such steps were still required.

f. Assess the Consequences

Take two or three differing alternatives and examine the long- and short-range consequences.

The CFO could support a favorable plan for the CEO

The CEO benefits from enhanced retirement benefits (if the outside auditors sign off)

The CFO may be rewarded by the CEO with increased salary or bonus.

The firm, including successor leaders and employees, may suffer from reduced earnings in the years following the CEO's retirement.

The CFO may have problems with successor leaders if his agreement to

the CEO's plan is discovered.

The CFO's integrity will be compromised.

The CFO could object to the proposals and refuse to sign off on them

The CEO may drop his plans to enhance his retirement.

The CEO may threaten to penalize the CFO's job security or income.

The CEO may take his plan to the Board without concurrence of the CFO.

The CFO's integrity will be intact.

The CFO could object to the proposals and threaten to go to the Board if the CEO persists

The CEO may drop his plans to enhance his retirement.

The CEO may threaten to penalize the CFO's job security or income.

The CFO may stand fast or may capitulate and agree.

The CEO may persist and the CFO may go to the Board.

The Board may reject the CEO's plans.

The Board may agree with the CEO.

The Board may seek the advice of the outside auditors.

The CFO's integrity is intact.

The CFO could communicate his concerns to the outside auditors.

The outside auditors may agree with the CFO and indicate that they will refuse to issue an unqualified report.

The outside auditors may support the CEO's plan.

The CFO will then have to drop the matter or decide whether to go to the Board.

The CFO's integrity will be intact.

(There may be additional consequences to alternatives reviewed. There may also be other alternatives. The task now is to weigh or evaluate the consequences of the various alternatives. Some kind of numerical weighting, like a +3, -3 scale, can be used to determine comparative value of alternatives. Point out to the class the difficulty of assigning numerical values, but also note that we do compare, routinely, the significance of various consequences, although not always quantitatively.)

(If a decision was not reached in Step e above, then no principle or value was determinative. Now the consequence with the highest numerical value should be the choice *if it squares with one of the basic listed principles and values.*)

g. Make Your Decision

Take a vote; insist that everyone choose.

Examine the outcome and rationale for different positions, if there is time.

TIME ALLOCATION

A full discussion and analysis of the case will take approximately an hour. If you are interested in focusing on the identification of ethical issues at various points in the course, you could deal with the identification of stakeholders and defining of the ethical issues in 15-20 minutes.

CASE 2-2 THE DANGEROUS MORALITY OF MANAGING EARNINGS

- a. According to the article, "most managers and their accountants know otherwise - that managing short-term earnings can be part of a manager's job."
- b. "It seems many managers are convinced that if a practice is not explicitly prohibited or is only a slight deviation from rules, it is an ethical practice regardless of who might be affected either by the practice or the information that flows from it."
- c. "A major finding of the survey was a striking lack of agreement. None of the respondent groups viewed any of the 13 practices unanimously as an ethical or unethical practice."
- d.
 - 1. On average, the respondents viewed management of short-term earnings by accounting methods as significantly less acceptable than accomplishing the same ends by changing or manipulating operating decisions or procedures.
 - 2. The direction of the effect on earnings matters. Increasing earnings is judged less acceptable than reducing earnings.
 - 3. Materiality matters. Short-term earnings management is judged less acceptable if the earnings effect is large rather than small.
 - 4. The time period to the effect may affect ethical judgments.
 - 5. The method of managing earnings has an effect.
- e. Management does not have the ability to manage earnings in the long run by influencing financial accounting.

CASE 2-3 FIRM COMMITMENT?

- a. Yes. SFAC No. 6, "Elements of Financial Statements:" "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."
- b. The airlines had millions and millions of miles accumulated in unused miles. Thousands of these accounts are inactive and will never accumulate adequate miles for a flight or any award. In addition, the airlines apparently have the right to change the terms for granting a flight or any awards.
- c.
 - 1. A contingent liability is dependent upon the occurrence or non-occurrence of one or more future events to confirm the liability.
 - 2. Yes. In practical terms, the unused miles represent a contingent liability. The situation is complicated by the fact that the airlines apparently have the right to make changes to their frequent-flier programs.
 - 3. Recommend that the contingent liability be recorded and the accounting policy be disclosed.

In practice, the airlines record this liability and briefly describe their policy. Seldom is the dollar amount of the liability disclosed.

Most airlines use the incremental method to account for their frequent flier awards. Once a program member accumulates the required number of miles to qualify for free travel, then the liability is recorded. The dollar amount of the liability is estimated at the incremental cost of providing the free transportation.

The incremental cost may be computed differently by each airline. Examples of cost factors to be considered are costs of food, additional fuel, issuing the ticket and handling of baggage.

CASE 2-4 RULES OR FEEL?

This case provides the opportunity to compare the IFRSs more principles-based with the U.S. rules-based GAAP

- a. U.S. accounting standards consists of hundreds of pages of rules. The principles-based approach (a broad-brush approach) relies more on companies to reasonably apply the rules. Some maintain that principles-based approach would result in more lawsuits. Others maintain that a principles-based approach would result in fewer lawsuits.
- b. This is an opinion question. Several reasons for giving up U.S. GAAP should be given along with several reasons for not giving up U.S. GAAP.

CASE 2-5 MATERIALITY: IN PRACTICE

(This case provides the opportunity to review the application of the materiality concept.)

- a. Professional standards require auditors to make a preliminary judgment about materiality levels during the planning of an audit. Therefore it would be prudent for auditors to give careful consideration to planning materiality decisions.
- b. SAS No. 47 recognizes that it ordinarily is not practical to design procedures to detect misstatements that could be qualitatively material.
- c. It is difficult to design procedures to detect misstatements that could be quantitatively material. Although difficult to design these procedures a number of rule of thumb materiality calculations have emerged. A difficulty with these rule of thumb materiality calculations is that sizeable differences can result depending on the rule of thumb.
- d. Because of the difficulty of applying the materiality concept it is often an issue in court cases involving financial statements.
- e. It is difficult to determine materiality as it relates to control weaknesses. But the materiality concept must be considered when reviewing for control weaknesses.

CASE 2-6 MANAGEMENT'S RESPONSIBILITY

- a. The official position as presented by the accounting profession is that the financial statements are the responsibility of the Company's management.
- b. The accountant (auditor) expresses an opinion on the financial statements based on the audit. The audit is to be conducted in accordance with generally accepted auditing standards.
- c. Society appears to focus on the role of the independent auditor as a public watchdog. This includes taking responsibility for the financial statements. This role is broader than the official position as to the responsibility of the accountant (auditor).

Another factor is that the accountant (auditor) is perceived as having the ability to pay, either directly, or by way of insurance.

- d. The Sarbanes-Oxley Act requires that management issue annually a report on internal control systems.

CASE 2-7 SAFE HARBOR

(This case provides the opportunity for the student to express opinions as to any benefits to users of financial reports from forward-looking statements.)

- a. Management is in an ideal position to project financial results. Users of financial reports will likely be aided in making decisions by the forward-looking statements of management.
- b. Yes. Investors will be aided in making decisions because of the forward-looking statements of management.

Abusive litigation is probably of little benefit to investors, since the lion's share of recoveries under the litigation may go to the attorneys who brought the suit than to the investors.

CASE 2-8 ENFORCEMENT

(This news release comments on the first disciplines of an accounting firm and auditors under the Sarbanes-Oxley Act of 2002).

- a. “The order bars Mr. Morris from association with a registered accounting firm and revokes the firm’s registration.” He could possibly work for a non registered accounting firm. He could also work in industry.
- b. Mr. Morris will not be able to function as a certified public accountant in a registered accounting firm. Mr. Morris apparently can still function as a certified public accountant outside a registered accounting firm.

Goldberger and Postelnik were only censured. There were no restrictions on where they could work.

Certification is granted by individual states. All three may have subsequent problems with New York State as to their certification.

CASE 2-9 VIEW OF FOREIGN FINANCIAL STATEMENTS REPORTED TO THE SEC

(Foreign financial statements can present a problem to the U.S. user. Are they presented in U.S. dollars? Are they presented using U.S. GAAP? Are U.S. auditing standards used?)

- a. Canadian collars
This will likely continue under IFRS.
- b. Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2008, based on the framework established in Internal Control – Integrated Framework issued by the sponsoring organizations of the Treadway Commission.
This will likely continue under IFRS.
- c. Canadian generally accepted auditing standards
This will likely continue under IFRS.
- d. No.

CASE 2-10 MULTIPLE COUNTRY ENFORCEMENT

(This case brings out that a company can be subject to securities enforcement actions in more than one country).

- a. The Netherlands company sold securities in the United States.
- b. The Netherlands is conducting a parallel criminal investigation because it was a Netherlands company selling securities in the Netherlands.
- c. Many countries may run parallel criminal investigations. Some companies register their securities on several exchanges around the world.

CASE 2-11 NOTIFY THE SEC

- a. Form 8-K
- b. The circumstances surrounding the resignation would be of interest to the public because this information could be important when valuing the company.

Note: Comments from the Administrative Proceeding

Legal Background

“Under the Exchange act, a public company must file with the Commission a report on Form 8-K when a director resigns from the board. If a director has resigned because of a disagreement with the company, known to an executive officer, on any matter relating to the company’s operations, policies, or practices, the company must, among other things, disclose a brief description of the circumstances of the disagreement. In addition, the company must give the director the opportunity for timely review and to respond to the company’s disclosure about the director’s resignation, and the company is required to file any letter written by the director to the company in response to the company’s disclosure. Absent such a disagreement, the company must report the resignation, but need not provide the reasons...”

HP Fails to Disclose the Reasons for Mr. Perkins’ Resignation

“HP executives understood that, in the event a director resigned over a disagreement with the company on a matter relating to its operations, policies, or practices, the company would need to report to the Commission (and thereby disclose to investors) the circumstances of the disagreement...”

“Accordingly, it is hereby ORDERED that Respondent HP cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rule 13a-11 thereunder.”

THOMSON ONE

This Merck & Company exercise uses the proxy statement to review the directors, board committees, and executive officers. Students find the Executive Officers compensation to be particularly interesting.