Chapter 2
Introduction to Financial Statements and Other Financial Reporting Topics

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 the ability of the business to continue on as a going concern.

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 depend on the outcome of a future event that financially may or may not be favorable to the company. Lawsuits represent contingent liabilities since their outcome may occur months or years in the future and the company may or may not incur a financial loss due to the outcome of the case.

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. Assets = Liabilities + Stockholders' equity (capital).

2-26. The scheme of the double-entry system revolves around the accounting equation:

Assets = Liabilities + 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. Adjusting entries are necessary to match revenues with the expenses that produced those revenues. This is the main tenant of accrual accounting. For example, at the end of the accounting cycle depreciation must be calculated to reflect the use of an asset.

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. 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

2-32. 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 and 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.

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 (Debit)	Insurance Expense (Credit)	Prepaid Insurance (Debit)	Prepaid Insurance (Credit)
(1)December 31 600		July 1 1,200	(1) December 31 600

Supplies Expense (Debit)	Supplies Expense (Credit)	Supplies (Debit)	Supplies (Credit)
(2) 300		September 10 500	(2) 300

Revenue (Debit)	Revenue (Credit)	Unearned Revenue (Debit)	Unearned Revenue (Credit)
(3) 1,000	December 1 1,000		(3) 1,000

Interest Expense (Debit)	Interest Expense (Credit)	Interest Payable (Debit)	Interest Payable (Credit)
(4) 200			(4) 200

Salaries Expense (Debit)	Salaries Expense (Credit)	Salaries Payable (Debit)	Salaries Payable (Credit)
(5) 500			(5) 500

Revenue (Debit)	Revenue (Credit)	Accounts Receivable (Debit)	Accounts Receivable (Credit)
	(6) 400	(6) 400	

PROBLEM 2-4

Prepaid Insurance (Debit)	Prepaid Insurance (Credit)	Insurance Expense (Debit)	Insurance Expense (Credit)
(1) 640		May 1 960	(1) 640

Supplies Expense (Debit)	Supplies Expense (Credit)	Supplies (Debit)	Supplies (Credit)
(2) 100		December 1 400	(2) 100

Interest Receivable (Debit)	Interest Receivable (Credit)	Interest Income (Debit)	Interest Income (Credit)
(3) 100			(3) 100

Salaries Expense (Debit)	Salaries Expense (Credit)	Salaries Payable (Debit)	Salaries Payable (Credit)
(4) 800			(4) 800

Unearned Revenue (Debit)	Unearned Revenue (Credit)	Revenue (Debit)	Revenue (Credit)
	(5) 600	(5) 600	

Accounts Payable (Debit)	Accounts Payable (Credit)	Advertising Expense (Debit)	Advertising Expense (Credit)
	(6) 400	(6) 400	

PROBLEM 2-5

a. __5__ The balance sheet equation is defined as assets are equal to liabilities plus stockholder's equity.

b. __1__ Assets ($40,000) = liabilities(?) + stockholders' equity ($10,000).

c. __3__ Assets ($100,000) = liabilities ($40,000) + stockholder's 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. __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 personal 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)

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

<u>PROBLEM 2-11</u>

Prepaid Insurance

December 31, 2011	180,000	
		320,000
Amount paid	310,000	
December 31, 2011	170,000	

Insurance Expense

X 320,00	

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 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 2-5 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 management can use their knowledge of accounting, finance and economics to prepare forward looking financial statements.

   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.

<u>CASE 2-9 NOTIFY THE SEC</u>

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."