Solutions for Auditing A Risk Based Approach 11th Edition by Johnstone

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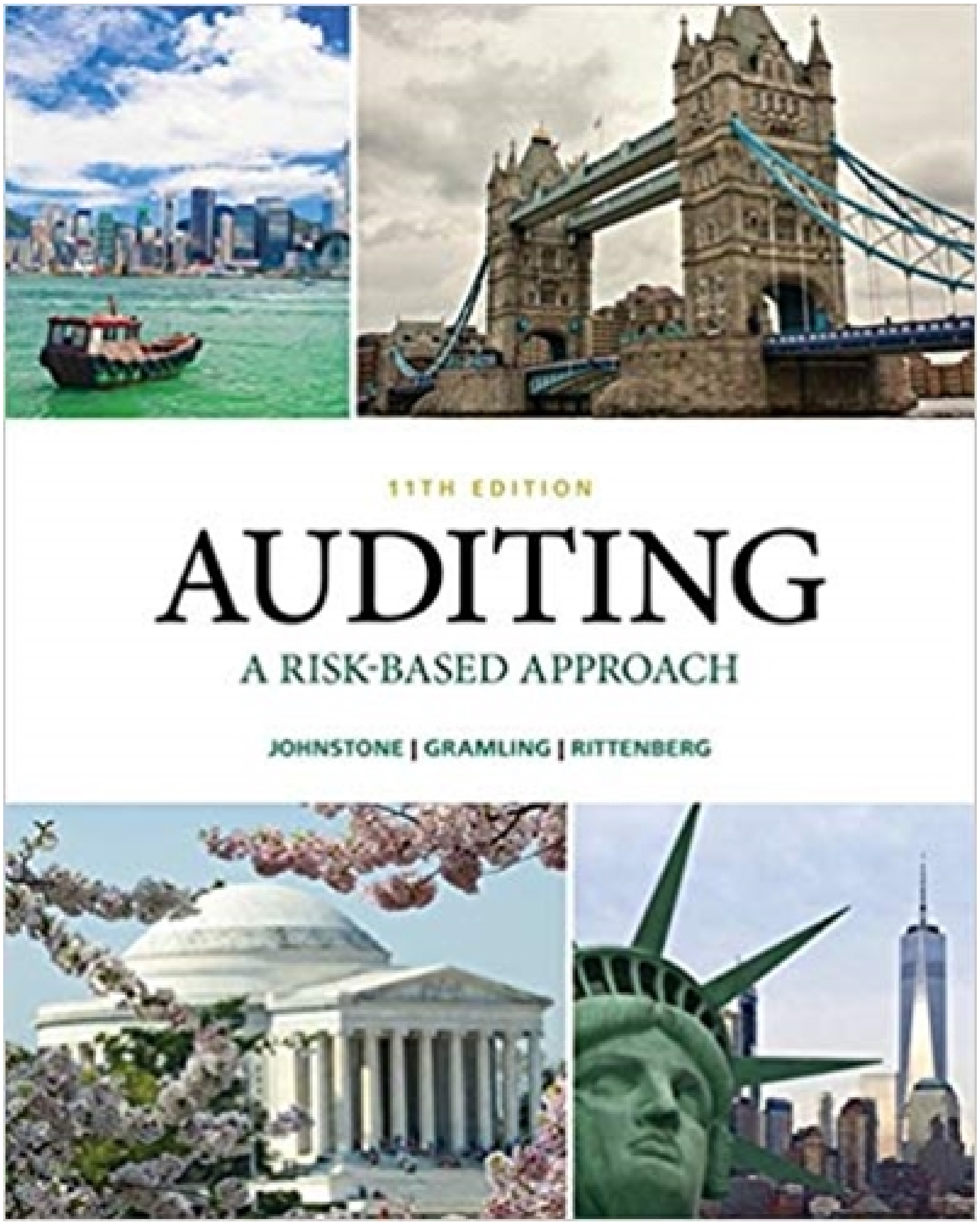


Solutions

__Financial Statement Auditing: A Risk-Based Approach, 11e__

Solutions for Chapter 2

Answers to Check Your Basic Knowledge Questions

2-1 F
2-2 F
2-3 b
2-4 b
2-5 T
2-6 F
2-7 b
2-8 e
2-9 T
2-10 T
2-11 d
2-12 c
2-13 F
2-14 F
2-15 c
2-16 d
2-17 F
2-18 T
2-19 a
2-20 d
2-21 T
2-22 T
2-23 a
2-24 b

Review Questions and Short Cases

2-1

Fraud is an intentional act involving the use of deception that results in a misstatement of the financial statements. Two types of misstatements are relevant to auditors' consideration of fraud: (a) misstatements arising from misappropriation of assets and (b) misstatements arising from fraudulent financial reporting. Intent to deceive is what distinguishes fraud from errors.

2-2

Three common ways that fraudulent financial reporting can be perpetrated include:

- Manipulation, falsification, or alteration of accounting records or supporting documents
- Misrepresentation or omission of events, transactions, or other significant information
- Intentional misapplication of accounting principles

Common types of fraudulent financial reporting include:

- Improper revenue recognition
- Improper deferral of costs and expenses
- Improper asset valuation
- Concealed liabilities
- Misrepresentations or omissions in financial statement footnotes of MD&A

2-3

The reporter's statement makes sense. Asset misappropriations are much easier to accomplish in small organizations that don't have sophisticated systems of internal control. Fraudulent financial reporting is more likely to occur in large organizations because management often has ownership of or rights to vast amounts of the company's stock. As the stock price goes up, management's worth also increases.

However, the reporter may have the mistaken sense that financial fraud only occurs rarely in smaller businesses. That is not the case. Many smaller organizations are also motivated to misstate their financial statements in order to (a) prop up the value of the organization for potential sale, (b) obtain continuing financing from a bank or other financial institution, or (c) to present a picture of an organization that is healthy when it may be susceptible to not remaining a going concern.

Finally, smaller organizations may conduct a fraud of a different sort; i.e., misstating earnings by understating revenue or masking owner distributions as expenses. This approach is often used to minimize taxes. It would also be a mistake to think that asset misappropriations do not happen in larger organizations. Whenever controls are weak, there is an opportunity for asset misappropriation. When the opportunity is coupled with motivation and a belief that the fraud could be covered up, some of those opportunities will result in asset misappropriation.

2-4

a. A Ponzi scheme occurs when the deposits of current investors are used to pay returns on the deposits of previous investors; no real investment is happening.

b. The key elements of the Bernie Madoff fraud include the following actions Madoff perpetrated, which led to the PCAOB now having oversight of the audits of SEC-registered brokers and dealers:

- Fabricated "gains" of almost $65 billion

- Defrauded thousands of investors
- Took advantage of his high-profile investment leader status to establish trust in his victims
- Accomplished the scheme by keeping all the fraudulent transactions off the real financial statements of the company
- Employed a CPA who conducted a sham audit

c. The Bernie Madoff fraud is primarily a case of asset misappropriation. However, it is important to note that asset misappropriation then led Madoff to commit fraudulent financial reporting to hide the asset misappropriation.

2-5

a. Management perpetrated the fraud by filling large containers with water and placing a layer of salad oil on top. Furthermore, they transferred the oil from tank to tank in the order in which they knew the auditors would proceed through the location.

b. The goal was to overstate inventory assets, thereby understating cost of goods sold and overstating income.

c. The Great Salad Oil Swindle is primarily a case of fraudulent financial reporting.

2-6

Incentives relate to the rationale for the fraud; e.g., need for money, desire to enhance stock price. Opportunities relate to the ability of the fraudster to actually accomplish the fraud; e.g., through weak internal controls, complex transactions. Rationalization is the psychological process of justifying the fraud.

2-7

Common incentives for fraudulent financial reporting include:

- Management compensation schemes
- Other financial pressures for either improved earnings or an improved balance sheet
- Debt covenants
- Pending retirement or stock option expirations
- Personal wealth tied to either financial results or survival of the company
- Greed—for example, the backdating of stock options was performed by individuals who already had millions of dollars of wealth through stock

2-8

Factors, or red flags, that would be strong indicators of opportunity to commit fraud include:

- inadequate segregation of duties
- opportunities for management override
- absence of monitoring controls

- complex organizational structure
- unauthorized access to physical assets
- inadequate reconciliations of key accounts, especially bank accounts
- access to cash that is not supervised or reconciled by someone else

2-9

The ability to rationalize is important. Unless fraudsters are outright criminals, they will often want to come up with an excuse for their behavior. “Accounting rules don’t specifically disallow it” or “the company owes me” are potential rationales. Other common rationalizations include:

- Unfair financial treatment (perceived) in relationship to other company employees
- “It is only temporary,” or “it’s a loan from the company”
- “I deserve it”
- “The company is so big, it won’t miss anything”
- “ The company is unethical”
- “The company comes by its profits in a way that exploits people”

2-10

a. incentive
b. incentive
c. opportunity
d. incentive
e. rationalization
f. opportunity

2-11

Refer to *Exhibit 2.3* for brief descriptions.

a. Enron: fraudulent financial reporting

b. WorldCom: fraudulent financial reporting

c. Parmalat: fraudulent financial reporting

d. HealthSouth: fraudulent financial reporting

e. Dell: fraudulent financial reporting

f. Koss Corporation: asset misappropriation

g. Olympus: fraudulent financial reporting

h. Longtop Financial Technologies: fraudulent financial reporting

i. Peregrine Financial Group: asset misappropriation

j. Sino-Forest Corporation: fraudulent financial reporting

k. Diamond Foods, Inc.: fraudulent financial reporting

l. Wells Fargo: asset misappropriation

m. Weatherford Int'l: fraudulent financial reporting

n. Lime Energy: fraudulent financial reporting

2-12

a. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence; requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist.

b. Professional skepticism is helpful in detecting fraud, because without it the external auditor will be easily convinced of alternative explanations that management will provide to conceal the fraud.

c. The key behaviors necessary to successfully exercise professional skepticism include validating information through probing questions, critically assessing evidence, and paying attention to inconsistencies.

d. It is difficult to exercise professional skepticism in practice for a variety of reasons, including the natural tendency to trust people (especially client personnel with whom you have worked), lack of repeated exposure to fraud, and many repeated exposures to situations that do NOT involve fraud.

e. Personal characteristics and behaviors that might make you skeptical about an individual include some of the following:

- Providing inaccurate or conflicting evidence
- Interacting in a difficult or unhelpful manner
- Acting in an untrustworthy fashion
- Engaging in conspicuous consumption of material possessions beyond the level to which his/her salary would normally make that lifestyle possible.

Publicly available evidence exists that might help you assess whether an individual warrants increased skepticism. Information can include: tax liens, credit scores, and legal filings.

2-13

a. If a company has good products, it would be expected that it should have comparable profitability with other industry participants. The fact that it does not have that profitability, coupled with a weakness in internal controls over disbursements, should lead the auditor to embrace the idea that there is an opportunity for a disbursement fraud and that such a fraud could be hurting the reported profitability of the company.

b. The company is doing better than its competitors, and it appears to have achieved these better results through cost control. While cost control might be a valid explanation, the auditor should consider other potential explanations such as inappropriately capitalizing expenses, inappropriately recognizing revenue, etc.

c. The company would appear to be using 'window dressing' in order to bypass debt covenants. It is doing so by sharply discounting current sales. These actions are not necessarily fraudulent, but they may be created to portray a misleading picture of the current economic health of the organization.

d. This brief description mirrors that of the Koss case where the CFO was very intimidating, not a CPA, and possessed limited accounting experience. The company did not increase profit during her tenure. The external auditor should consider these factors to suggest a heightened risk of fraud.

2-14

Some of the key findings by COSO:

- The amount and incidence of fraud remains high
- The median size of the company perpetrating the fraud rose tenfold to $100 million during the 1998-2007 time period
- There was heavy involvement in the fraud by the CEO and/or CFO
- The most common fraud involved revenue recognition
- Many of the companies committing fraud changed auditors
- The majority of the frauds took place at companies that were listed on the over-the-counter (OTC) market rather than those listed on the NYSE or NASDAQ

2-15

a. The various failures and environmental characteristics during the time of the Enron fraud include:

- Weak management accountability
- Weak corporate governance
- Accounting became more rule-oriented and complex
- The financial analyst community was unduly influenced by management pressure
- Bankers were unduly influenced by management pressure
- Arthur Andersen was unduly influenced by management pressure, especially since consulting revenues at Enron were very high

b. In terms of the fraud triangle,

- Incentives: Management was very concerned about managing stock prices through keeping debt off the balance sheet; the underlying business model of the company was not working; the company had strayed too far away from its "utility" roots; and employees were taking significant risks in the financial markets that did not yield expected profits, thereby creating strong incentives for top management to conduct the fraud.

- Opportunity: Corporate governance and external auditor accountability were lacking.

- Rationalization: Although not discussed in the text specifically, there have been speculations in the press that management thought they were smarter than everyone else and that they were very confident that they could get away with the fraud. It is difficult to know the internal rationalizations of top management.

2-16

Auditing standards historically have reflected a belief that it is not reasonable for auditors to detect cleverly implemented frauds. However, it is increasingly clear that the general public expects that auditors have a responsibility to detect and report on material frauds. Professional auditing standards do require the auditor to plan and perform an audit that will detect material misstatements resulting from fraud. As part of that requirement, auditors will begin an audit with a brainstorming session that focuses on how and where fraud could occur within the organization. Auditors also need to communicate with the audit committee and management about the risks of fraud and how these risks are addressed. The auditor should then plan the audit to be responsive to an organization's susceptibility to fraud.

2-17

The three ways in which individuals involved in the financial reporting process, including the external auditor, can mitigate the risk of fraudulent financial reporting include:

- Acknowledging that a strong, highly ethical tone needs to exist at the top of an organization that permeates the corporate culture, including an effective fraud risk management program.
- Continually exercising professional skepticism, a questioning mindset that strengthens professional objectivity, in evaluating and/or preparing financial reports.
- Remembering that strong communication among those involved in the financial reporting process is critical.

Will these actions be effective? This should promote a lively debate among students if this question is discussed in class. Some will argue that frauds happen no matter what, so these types of actions will be futile. Others will be more optimistic, arguing that these actions, if consistently applied, could help to mitigate fraud risk.

2-18

a. The financial literacy, integrity, and reputation of board members enhance credibility of the regulation and oversight of the auditing profession. Inspections by the PCAOB act as a highly visible enforcement mechanism, hopefully leading to higher quality audits. Furthermore, information that is learned through the inspection process can be used as a basis for modifying and enhancing auditing standards.

b. These sections improve auditor independence by separating consulting and auditing by the same audit firm. The partner rotation requirement ensures that a “fresh set of eyes” will be responsible for oversight on the engagement.

c. The “cooling-off” period helps to avoid conflicts of interest between top members of the engagement team and the client. By requiring a cooling-off period, an auditor will not be unduly influenced (or appear to be unduly influenced) by the possibility of high-level employment with the client.

d. Audit committees clearly serve the role of the “client” of the auditor. They act as surrogates for the shareholders who are the actual audit client. They act as the liaison between management and the external auditor. By being independent, they gain credibility and ensure that the external auditor can rely on them to perform their governance role. By requiring that audit committees can hire their own attorneys and by ensuring that they have adequate monetary resources, the external auditor has confidence that they will act as truly independent monitors of management.

e. The certification requirements of the Sarbanes Oxley Act of 2002 help address the risk of fraud by forcing the CEO and CFO to take internal controls and high quality financial reporting seriously. The Act requires the CEO and CFO to affirmatively sign the financial statements. As such, they will likely require individuals below them to provide assurance that those departments or organizational units are each committed to internal controls and high quality financial reporting as well. Of course, a signature is just a signature! So, the likelihood that a CFO who is committing fraud will certify falsely is probably 100%. Thus, this mechanism is not without practical flaws.

f. It addresses off-balance sheet transactions and special purpose entities, which were the main mechanisms used to conduct the Enron fraud.

g. A strong internal control system is critical to preventing fraud. These sections of the Sarbanes-Oxley Act mandate the disclosure of weak internal controls, thereby providing a strong motivation to managers to ensure that controls are effective. By requiring external auditor assurance on management’s assessment, financial statement users can believe in management’s assertions about controls.

h. One member of the audit committee needs to be a financial expert to ensure that there is the knowledge necessary on the audit committee to critically evaluate management’s financial reporting and internal control choices. Without that knowledge, the committee may be unduly influenced by management's preferences.

2-19

No, nonpublic organizations are not required to abide by the Sarbanes-Oxley Act. However, many organizations view these requirements as "best practice," and so nonpublic organizations sometimes voluntarily adhere to certain requirements of the Sarbanes-Oxley Act.

2-20

Refer to *Exhibits 2.6* and *2.7*.

2-21

These principles include:

- The board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation.
- Successful corporate governance depends upon successful management of the company, since management has the primary responsibility for creating a culture of performance with integrity and ethical behavior.
- Effective corporate governance should be integrated with the company's business strategy and not viewed as simply a compliance obligation.
- Transparency is a critical element of effective corporate governance, and companies should make regular efforts to ensure that they have sound disclosure policies and practices.
- Independence and objectivity are necessary attributes of board members; however, companies must also strike the right balance in the appointment of independent and non-independent directors to ensure an appropriate range and mix of expertise, diversity, and knowledge on the board.

2-22

a. Independent directors are more likely to stand up to management and report fraud than those directors that are not independent.

b. Holding meetings without management present enables a frank and open discussion, including enabling board members with concerns about potential fraud or weak management to alert other board members and express these concerns.

c. By having a nominating/corporate governance committee composed of independent directors, the organization is more likely to attract high quality board members that are not unduly influenced by management. And by having a corporate governance committee, this important element of control achieves prominence in the organization and acts as a deterrent to fraud.

d. Having a written charter and an annual performance evaluation ensures that the committee responsibilities are appropriate, and that the responsibilities are actually accomplished (or shareholders are alerted if they are not accomplished). Accomplishing such activities acts as a deterrent to fraud.

e. By having an independent compensation committee, top management will be less able to inappropriately influence compensation decisions for themselves.

f. Having a written charter and an annual performance evaluation ensures that the committee responsibilities are appropriate, and that the responsibilities are actually accomplished (or shareholders are alerted if they are not accomplished). Accomplishing such activities acts as a deterrent to fraud.

g. This requirement ensures an adequate size and independence of the audit committee, which acts to strengthen governance and deter fraud.

h. Having a written charter and an annual performance evaluation ensures that the committee responsibilities are appropriate, and that the responsibilities are actually accomplished (or shareholders are alerted if they are not accomplished). Accomplishing such activities acts as a deterrent to fraud.

i. These requirements encourage a high quality set of corporate governance behaviors, which taken together act as a deterrent to fraud.

j. By making the ethics issue a prominent disclosure, it encourages management and other individuals within the organization to take it more seriously. It acts to encourage a high quality "tone at the top."

k. By requiring this disclosure, users of the financial statements can evaluate for themselves whether the foreign companies' governance is adequate, or gain an appreciation for governance differences. This knowledge encourages companies to adopt corporate governance mechanisms that they otherwise may not, thereby affecting the control environment and the opportunity for fraud. It also helps users know where deficiencies may exist, making them more skeptical.

l. It attempts to ensure that top-level executives place appropriate importance on corporate governance and that they would be required to disclose if their company is not compliant, which would alert users to heightened fraud risk.

m. An internal audit function is important to the control environment. Having that oversight internally improves internal control, thereby deterring fraud.

2-23

a. This requirement forces audit committees to take internal controls seriously, and to consider any potential independence impairments for the external auditor. Both internal controls and high quality external auditing are critical for the prevention and/or detection of fraud.

b. This requires the audit committee to be engaged and informed about financial accounting at the company; being engaged and informed enhances the ability of the audit committee to detect fraud.

c. Analyst interactions and the pressure to meet their expectations provide incentives for fraud. By requiring that the audit committee discuss the earnings release process, this ensures that audit committees have more control over how management engages with analysts, and this control should assist in deterring fraud.

d. Understanding risk assessment and risk management should alert the audit committee to weaknesses in the company, thereby encouraging positive change, which should thereby deter fraud.

e. Meeting separately with these groups encourages frank conversations about concerns, and such communication is helpful to deterring or detecting fraud.

f. By understanding the nature of any problems that the external auditor is having with management, the audit committee gets a good sense of potential management aggressiveness and the sources of disagreement between the auditor and management. In addition, this requirement gives the external auditor someone to turn to in reporting fraud on the part of management.

g. By setting hiring policies pertaining to employees of the external audit firm, the audit committee can ensure that management is not exerting undue influence over the members of the audit team by possibly promising them employment at the company.

h. By reporting regularly to the board of directors, the audit committee is put in a position of power in the organization, thereby giving it the clout necessary to oversee management and deter fraud.

2-24

a. The audit committee must be comprised of "outside" independent directors, one of whom must be a financial expert. The audit committee now has the authority to hire and fire the external auditor, and will therefore serve as the auditor's primary contact, especially for accounting and audit-related issues. In addition, at many organizations the audit committee sets the scope for and hires internal auditors. It would also review the work of both internal and external auditors.

b. The audit committee certainly takes on much more responsibility with the new regulation. It will now be much more informed about the audit function and financial reporting processes within the company it evaluates. The auditor must report all significant problems to the audit committee. For auditors, the reporting relationship should reinforce the need to keep the third-party users in mind in dealing with reporting choices.

c. The audit committee is basically in a position of mediator, but not problem solver. One member must be a financial expert, but all members must be well versed in the field. This financial knowledge can help the audit committee to understand the disagreement. Ultimately, the company would like to receive an unqualified audit opinion. If the external auditor believes a certain accounting treatment to be wrong, the committee does not have to give an unqualified opinion. The audit committee's responsibility is to assist in resolution of the dispute so that financial reporting is accurate. Skills of audit committee members that would assist in this type of situation include interpersonal skills, negotiation skills, and communication skills.

2-25

Factors	Explain Your Reasoning and Indications of Poor Governance
a. The company is in the financial services sector and has a large number of outstanding consumer loans, including mortgages,.	This is not necessarily poor governance. However, the auditor needs to determine the amount of risk that is inherent in the current loan portfolio and whether the risk could have been mitigated through better risk management by the organization. The lack of good risk management by the organization increases the risk that the financial statements will be misstated because of the difficulty of estimating the allowance for loan losses.
b. The CEO's and CFO's compensation is based on three components: (a) base salary, (b) bonus based on growth in assets and profits, and (c) significant stock options.	This is a rather common compensation package and, by itself, is not necessarily poor corporate governance. However, in combination with other things, the use of 'significant stock options' may create an incentive for management to potentially manage reported earnings in order to boost the price of the company's stock. The auditor can determine if it is poor corporate governance by determining the extent that other safeguards are in place to protect the company.
c. The audit committee meets semi-annually. It is chaired by a retired CFO who knows the company well because she had served as the CFO of a division of the firm before retirement. The other two members are local community members – one is the President of the Chamber of	This is a strong indicator of poor corporate governance. If the audit committee meets only twice a year, it is unlikely that it is devoting appropriate amounts of time to its oversight function, including reports from both internal and external audits. There is another problem in that the chair of the audit committee was previously employed by the company and would not meet the definition of an independent director.

Factors	Explain Your Reasoning and Indications of Poor Governance
Commerce and the other is a retired executive from a successful local manufacturing firm.	Finally, the other two audit committee members may not have adequate financial experience. This is an example of poor governance because (1) it signals that the organization has not made a commitment to independent oversight by the audit committee, (2) the lack of financial expertise means that during the course of the audit the auditor does not have someone independent with whom controversial accounting or audit issues can be discussed. If there is a disagreement with management, the audit committee does not have the expertise to make independent judgments on whether the auditor or management has the appropriate view of the accounting or audit issues.
d. The company has an internal auditor who reports directly to the CFO, and makes an annual report to the audit committee.	The good news is that the organization has an internal audit function. However, the reporting relationship is not ideal. Furthermore, the bad news is that a staff of one isn't necessarily as large or as diverse as it needs to be to cover the major risks of the organization.
e. The CEO is a dominating personality – not unusual in this environment. He has been on the job for 6 months, and has decreed that he is streamlining the organization to reduce costs and centralize authority (most of it in him).	A dominant CEO is not especially unusual, but the centralization of power in the CEO creates a risk that many aspects of governance, as well as internal control, could be overridden, which of course increases the risk of fraud and the risk faced by the external auditor.
f. The company has a loan committee. It meets quarterly to approve, on an ex-post basis, all loans that are over $300 million (top 5% for this institution).	There are a couple of elements in this statement that yield great risk to the audit and to the organization, and that are indicative of poor governance. First, the loan committee only meets quarterly. Economic conditions change more rapidly than once a quarter, and thus the review is not timely. Second, the only loans reviewed are (a) large loans that (b) have already been made. Thus, the loan committee does not act as a control or a check on management or the organization. The risk is that many more loans than would be expected could be delinquent and need to be written down.
g. The previous auditor has resigned because of a dispute regarding the accounting	This is a very high risk indicator that is indicative of poor governance. The auditor would look extremely bad if the previous auditor resigned over a valuation issue and the new

Factors	Explain Your Reasoning and Indications of Poor Governance
treatment and fair value assessment of some of the loans.	auditor failed to adequately address the same issue. Second, this is a risk factor because the organization shows that it is willing to get rid of auditors with whom it does not agree. This is a problem of auditor independence, and coincides with the above identification of the weakness of the audit committee.

Fraud Focus: Contemporary and Historical Cases

2-26

a. Management at Koss may have placed a high level of trust in Sachdeva because they knew her for a long period of time and she did not exhibit behaviors that caused concern. Furthermore, management at the company was reportedly quite relaxed in its approach to monitoring and control. These behaviors led to a lack of professional skepticism on the part of management.

b. Grant Thornton was obligated to uncover the fraud in the sense that it ignored red flags (weakening financial condition, poor internal control and monitoring) that should have alerted it to problems in the company. Grant Thornton experienced an audit failure because it issued unqualified audit opinions on materially misstated financial statements. It appears that Grant Thornton may not have employed an appropriate level of professional skepticism.

c. Sachdeva's lavish lifestyle should have raised suspicions because her level of conspicuous consumption far exceeded her apparent ability to pay, given her relatively modest salary. However, her lifestyle may have been explained away or ignored because of her husband's prominent medical practice. People likely assumed that her lifestyle was none of their business and that she simply used her family's joint money to fund her lavish purchases. Even when confronted with a known fraud, individuals that know a fraudster often have difficulty believing that it is true – denial is a common factor even in the face of seemingly obvious signs of fraud.

d. Management and the audit committee should have been skeptical of Sachdeva because of the weak internal controls in place, coupled with deteriorating financial conditions at the company. The auditors should have been more skeptical of her explanations for the financial condition of the company. They should have collected more audit evidence to better understand the increase in cost of goods sold. Also, the auditors should have realized that there was a risk of fraud given the lack of monitoring and the high level access to corporate bank accounts that Sachdeva had.

e. The audit committee plays an important oversight role in any organization. The benefit of the audit committee should be that it is independent from the daily operations of the organization, and should therefore be in a position to more critically evaluate the personalities and behaviors of senior management, including the CFO in this particular case. Furthermore, audit committees of public companies are required to have at least one financial expert, and it is the obligation of that individual to consider and initiate investigation of anomalies in the financial statements. Clearly this oversight did not occur in the case of Koss.

f. Whenever an organization uses corporate credit cards, there should be controls over their use. Most typically, such controls involve review and approval of payment by a senior official. In Sachdeva's case, senior management allowed her to use the credit cards without review, and she was the individual in charge of making payments on the cards. Thus, basic controls involving review and segregation of duties were not used at Koss.

g. Top-level managers should have been skeptical about the reasons for Sachdeva's behavior. In retrospect, it seems that she was purposely trying to intimidate her subordinates through this dominating behavior. Management may have questioned why she was trying to intimidate her subordinates. Was there something that she was trying to cover up? This tactic was also used at Enron, whereby top-level management would explicitly indicate that any questioning of its actions (from employees, external analysts, etc.) was an indication of how dense the questioner was. Top-level managers should have wondered why she felt the need to behave in this manner, and they should have objected to it in person or at least told her in private to eliminate the behavior if for no other reason than to establish and maintain a more professional tone in the workplace. This kind of behavior puts subordinates in a very awkward position. In Sachdeva's case, she reportedly acted domineering to the vast majority of her subordinates. In such a setting where one individual is not singled out, it should be easier for the group to act cohesively and approach senior management privately to complain about the situation. In a setting where one individual is singled out, that individual should consider finding a formal or informal mentor to provide assistance in deciding how to garner the support to approach senior management with his or her concerns.

2-27

a. Yes, the members of the audit committee appear to be professionally qualified. They have all held financially responsible leadership positions at large companies in industries similar to those as Koss Corporation. The committee meets less frequently than quarterly, which is fairly infrequent. Prior to SOX, this level of audit committee involvement was common, but it is now more likely for audit committees of public companies to meet at least bi-monthly, if not monthly. Without frequent meetings, committee members are not able to generate sufficient questions and then gather sufficient evidence in order to develop a professionally skeptical view of the true situation at the company, and that is what appears to have happened at Koss. You might consider gathering evidence to support your conclusions about the professional qualifications of audit committee members. For example, you might observe the questions that they ask during meetings, and their level of preparedness. You might inquire about their continuing professional education and experiences. You will obtain this information in various ways, but personal observation will likely be very important.

b. Lawrence Mattson is the audit committee financial expert. He is a retired president of a large consumer products company, which should make him financially knowledgeable. However, the fact that he has clearly been retired for quite some time (he is in his late 70's) calls into question whether he is currently "up to speed" on the financial reporting demands faced by a public company. Without adequate financial knowledge, it is nearly impossible to exercise adequate professional skepticism – knowledge is one of the bases upon which skepticism rests. Financial expertise is important for audit committee members because they play a significant role in corporate governance over financial matters – they are a key defense in potential problems with financial reporting.

c. Their compensation is very low given the important role that they play in the company, and the fact that this is a public board. Furthermore, many audit committee members at public companies receive stock options or stock grants to align their interests with the long-term goals of stockholders. These audit committee members receive no stock options, and hold very few (if any) shares.

d. Theodore Nixon is the only audit committee member who is still an active, working financial professional. The other members of the audit committee are relatively older, and are no longer working in the public sector. This certainly does not disqualify them, but coupled with the relatively few meetings that the committee has, it calls into the question whether the audit committee is really functioning in a strong oversight capacity. The responsibilities that the proxy statement outlines seem reasonable, but it seems impossible that an audit committee with these characteristics could carry out those responsibilities in so few meetings.

2-28

This exercise is based on an article in the *Wall Street Journal* ("Dell Investors Protest CEO in Board Vote," by Joann S. Lublin and Don Clark, Aug. 18, 2010). The article provides more details on shareholder voting for directors if the instructor is interested in pursuing that aspect of governance. In terms of the specific questions:

a. The following are the corporate governance principles presented in the chapter. Students could argue that many of the principles could be in question at Dell. Of great concern is that management has a great deal of control over the governance, and there are questions about management's ethics and integrity. If the financial statements were intentionally misstated, this calls into question the company's commitment to transparency. Furthermore, given Mr. Dell's roles, there are questions about the independence of the board.

- The Board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation.
- Successful corporate governance depends upon successful management of the company, as management has the primary responsibility for creating a culture of performance with integrity and ethical behavior.
- Good corporate governance should be integrated with the company's business strategy and

not viewed as simply a compliance obligation.
- Transparency is a critical element of good corporate governance, and companies should make regular efforts to ensure that they have sound disclosure policies and practices.
- Independence and objectivity are necessary attributes of board members; however, companies must also strike the right balance between the appointment of independent and non-independent directors to ensure that there is an appropriate range and mix of expertise, diversity, and knowledge on the board.

b. The discussion in part a. suggests that Dell's auditors should have some concerns about the quality of governance at Dell. In turn, this concern suggests that the audit might have heightened risk of fraud.

c. Dell's auditor can respond in various ways. At the extreme, the auditor may decide to not retain Dell as a client. Another approach would be to increase the audit work and audit rigor to mitigate any risks that may be associated with the lower quality governance. However, if the governance is really poor, extra audit work may not be sufficient. Furthermore, if the auditors have reason to question the integrity and ethics of Mr. Dell, it could be hard to "audit around that." This is a setting where it is important that the auditors employ an appropriate level of professional skepticism.

d. In general, having an independent board chair would improve governance. Given the alleged behavior of Mr. Dell, it may be even more important at Dell, Inc. Recall, however, that no individual or company admitted wrongdoing in this case.

e. Removing Mr. Dell from his CEO position may not be as likely as removing him from his board position. Student discussion will likely not come to a consensus on this point.

2-29

a. Yes, auditors can commit fraud through their deliberate, negligent actions. When auditors sign an audit opinion, they are asserting that they have complied with professional auditing standards in arriving at their conclusion. In this case, it is clear that William Uniack failed to comply with professional auditing standards; thus, we can conclude that he provided a knowingly false and misleading audit report, which constitutes fraud.

b. See paragraph 12 of the enforcement action, which reads as follows:

"In connection with the audit, Respondents failed to exercise due professional care, including professional skepticism, and failed to plan and perform the audit in accordance with PCAOB standards. During audit planning, Respondents failed to develop and document an audit plan that included a description of the planned nature, timing, and extent of risk assessment procedures. Consistent with this planning deficiency, Respondents failed to identify and assess the risks of material misstatement at the financial statement and assertion levels. Respondents also failed to plan and perform any analytical procedures as risk assessment procedures. Respondents also failed to identify any risks with respect to revenue recognition and management override of controls, even though PCAOB standards provide that the auditor should presume that there is a fraud risk involving improper revenue recognition and should include the risk of management override of controls in his identification of fraud risks. Respondents also failed to perform audit procedures in a manner that addressed the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure."

c. Some auditing firms try to 'game the system' by providing an audit report without really conducting an audit. This is called a 'sham audit,' whereby the audit firm is essentially providing its opinion without performing the appropriate procedures. Clients that desire a low-quality audit hire these types of very low quality auditors because they know that the auditor will not do a quality audit. So, there is really fraud going on with both the client and the audit firm.

2-30

a. The student will be able to obtain insights on this case from a variety of online news sources. News accounts of this case indicate the following red flags: Beazer's culture was to "make the numbers" during a time when housing sales had significantly slowed; ; the company's employees were dealing with unrealistic budgets and pressure to achieve financial goals; the company had weak internal controls; Beazer was likely not recording impairments on its land assets in a timely manner; and Beazer's financial periods were regularly held open or re-opened.

b. When red flags are present, auditors need to alter the nature, timing, and extent of auditing procedures to adequately address the heightened risk of misstatement indicated by the red flags. In the case of many red flags, auditors should employ a heightened degree of professional skepticism.

c. Students will likely vary in their reactions to Deloitte's settlement. Some will take the position provided by the firm's spokesperson. Others will suggest that Deloitte was indeed liable and that a court case would have resulted in a guilty verdict, thereby subjecting Deloitte to even higher settlement costs.

2-31

a. The skepticism continuum is founded on the belief that professional skepticism is related to a questioning mind, and that an individual's mindset may range from neutral to presumptive doubt to complete doubt. Complete trust would be outside the range on the continuum of professional skepticism. The continuum then relates to evidence collection, whereby lower skepticism is associated with less audit evidence and documentation and higher skepticism is associated with more audit evidence and documentation.

b. Threats to individual auditor professional skepticism include judgment biases, lack of knowledge and expertise, deadline pressures, auditor character/personal attributes, cultural attributes, and performance incentives. Mitigating factors include professional education and licensing requirements, supervision, review, performance metrics that reward the auditor for quality work, effective recruiting requirements, effective engagement partner leadership, and training.

c. Common human judgment tendencies that can weaken individual auditor professional skepticism include the following:

- Overconfidence—The tendency of individuals to overestimate their own abilities. Overconfidence can lead the auditor to not spend enough time critically thinking about client-related facts that would otherwise raise red flags.
- Confirmation—The tendency of individuals to seek information and evidence that supports their initial beliefs or preferences. If individual auditors do not seek contradictory evidence, their professional skepticism is not heightened because the auditor does not detect discrepancies.
- Anchoring—The tendency of individuals to evaluate information from a starting point and then not adjusting sufficiently away from that starting point despite evidence to the contrary. For example, the individual auditor may anchor on last year's account balance or procedures used last year and insufficiently adjust for new information.
- Availability—The tendency of individuals to consider information that is more easily available from memory to be more likely, relevant, or important. By focusing on more readily available information, the individual auditor may not make the effort to engage in critical thinking about patterns available in audit evidence.

2-32

This research question asks students to summarize the PCAOB's concerns with respect to problems their inspection teams have noted in auditors' performance in each of the following areas.

a. Auditors' overall approach to the detection of fraud

Problems noted:

1. Auditors often document their consideration of fraud merely by checking off items on standard audit programs and checklists rather than by considering unique features of their individual clients.

2. Lack of involvement by senior members of the engagement team.

3. Failure to expand audit procedures despite recognition of heightened fraud risk.

b. Brainstorming sessions

Problems noted:

1. Engagement teams have been found not to conduct brainstorming sessions.

2. Brainstorming sessions were sometimes conducted AFTER audit evidence collection had begun, rather than as an integral part of the planning process.

3. Key members of the engagement team did not attend the brainstorming session.

c. Auditors' responses to fraud risk factors

Problems noted:

1. Auditors sometimes do not address known fraud risk factors via evidence.

2. Auditors sometimes collect evidence, but do not tie it to specific known fraud risk factors.

d. Financial statement misstatements

Problems noted:

1. Failure to appropriately determine whether items are material or not.

2. Failure to investigate known departures from GAAP to determine if those departures were indicative of fraud.

3. Failure to post material items to a summary sheet indicating material misstatements, or inappropriately netting misstatements. This causes senior engagement personnel and audit committee members to be unaware of problems that engagement teams encountered on the engagement that could be indicative of fraud.

e. Risk of management override of controls

Problems noted:

1. Failure to evaluate the risk of management override of controls.

2. Failure to evaluate the fraud risk potential associated with end of period journal entries or accounting estimates.

3. Failure to document or test management's assumptions about accounting estimates.

f. Other areas to improve fraud detection

Problems noted:

1. Improper use of analytical procedures in fraud detection.

2. Failure to adequately audit accounts receivables, which are related to revenue recognition (an area in which auditors are supposed to presume fraud)

3. Failure to determine that interim audit testing appropriately rolled forward to apply to end-of-year conclusions.

2-33

a. The PCAOB sets standards for audits of public companies and defines the auditing profession's responsibilities for detecting fraud and other financial misdeeds. It also establishes and tests quality control guidelines for external audit firms that audit public companies. The inspection process keeps the external audit profession acutely alert to its responsibilities of assuring audit quality; i.e., the threat of inspection should lead to more consistently high audit quality on all engagements even though not all engagements will actually be inspected.

b. The rationale for the requirement was probably to get people from diverse disciplines to comprise the board. This way, more thoughts are generated. Congress probably was under the impression that CPAs tend to think alike. The disadvantage to having only two CPAs on the board is that they do not form a majority and that the board may not have a sufficient level of accounting and auditing expertise. The board sets standards for an industry made up almost entirely of CPAs, yet the strongest voice may not be that of a CPA.

c. No, the audit standards promulgated by the PCAOB apply only to public listed companies in the U.S. However, many of the auditing standards that have been adopted by the PCAOB include U.S. audit standards originally developed by the Auditing Standards Board of the AICPA.

2-34

a. Shareholders would normally not know what qualifications are important for their external auditors. If the CEO or CFO had these responsibilities, the auditor would be more likely to bend to their wishes rather than take the hard stances that may be required for fair financial reporting. Part of the purpose of designating the audit committee to oversee the audit is to have an advocate for the stockholders of the company.

b. Factors to consider in evaluating the external auditor's independence include:

- The nature and extent of non-audit services provided to the client.
- The policies and procedures the external auditor's firm has to assure independence.
- The lengths of time individuals have been in charge of the audit.
- Any pending or completed investigations by the SEC or PCAOB of the firm.

c. This part of the problem will vary based upon the company that each student selected. This is a good problem to assign if you feel that your students are unfamiliar with locating basic public company filings using the SEC online data system.

2-35

The purpose of this project is to get students familiar with resources related to businesses and acquaint them with the process of gathering evidence about corporate governance and evaluating the effectiveness of corporate governance. Another alternative is to discuss what students have observed in their part-time jobs.

2-36

The goal of this exercise is to allow the student to see how audit committees really function in the "real world." The differences between the various companies will likely indicate that audit committees, charters, and company goals differ across organizations.

2-37

This exercise illustrates that the issue of corporate governance is a global issue. The insights the students will obtain will depend, in part, on the countries selected for research.

Academic Research Cases

2-38

A summary of the study can be accessed at http://commons.aaahq.org/posts/1c65a3aadc.

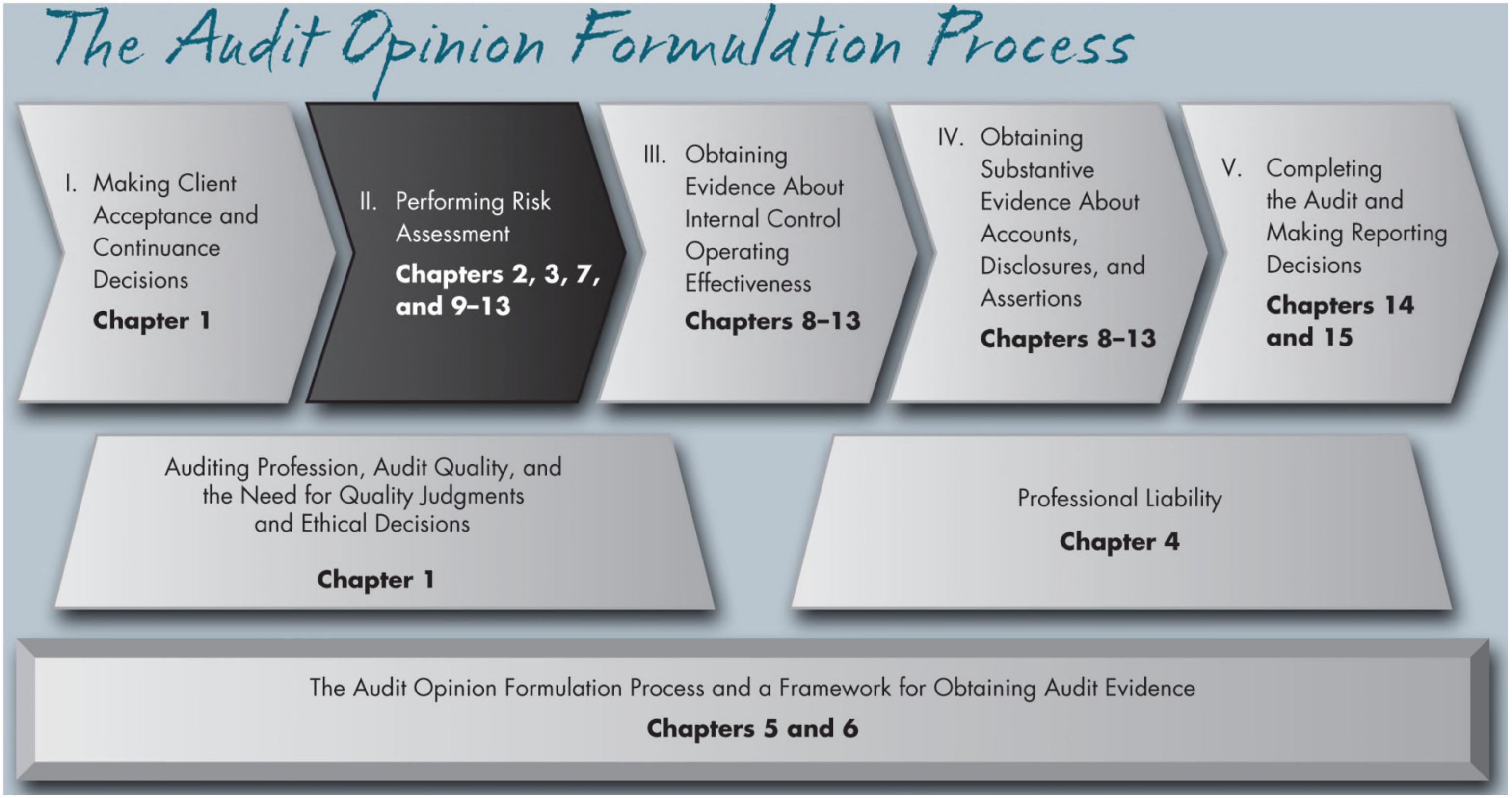
2-39

A summary of the study can be accessed at http://commons.aaahq.org/posts/725f4db30d.

CLICK HERE TO ACCESS THE COMPLETE Solutions

CHAPTER 2

The Auditor’s Responsibilities Regarding Fraud and Mechanisms to Address Fraud: Regulation and Corporate Governance



Learning Objectives

LO 1 Define the various types of fraud that affect organizations.

LO 2 Define the fraud triangle and describe its three elements.

LO 3 Describe implications for auditors of instances of fraudulent financial reporting and related fraud findings.

LO 4 Discuss auditors' fraud-related responsibilities and users' fraud-related expectations.

LO 5 Explain how various requirements in the Sarbanes-Oxley Act of 2002 help prevent fraud.

LO 6 Define corporate governance, identify the parties involved, and describe their respective activities.

Fraud Defined

- Fraud is an intentional act involving the use of deception that results in a misstatement of the financial statements
- Two types of misstatements are relevant to auditors' consideration of fraud:
  - Misstatements arising from misappropriation of assets
  - Misstatements arising from fraudulent financial reporting
- Intent to deceive is what distinguishes fraud from errors

Misappropriation of Assets

- Asset misappropriation occurs when a perpetrator steals or misuses an organization's assets
- Asset misappropriations
  - Primary fraud scheme in small businesses
  - Perpetrators are usually employees
- Asset misappropriations include
  - Embezzling cash receipts
  - Stealing assets
  - Causing the organization to pay for goods or services that the organization did not receive

Example of Misappropriation of Assets

- A Ponzi scheme occurs when a fraudster uses deposits of new investors to pay returns on the deposits of previous investors; no real investment is happening

Madoff Ponzi Scheme

- Madoff scheme is an example of asset misappropriation
  - Federal investigators believe the fraud began as early as the 1980s
  - Madoff's investment operation may never have been legitimate
  - Almost $65 billion was missing from client accounts, including fabricated gains
  - March 2009—Madoff pleaded guilty to 11 federal crimes
  - June 2009—Madoff was sentenced to 150 years in prison
- Refer to Exhibit 2.1 for additional details

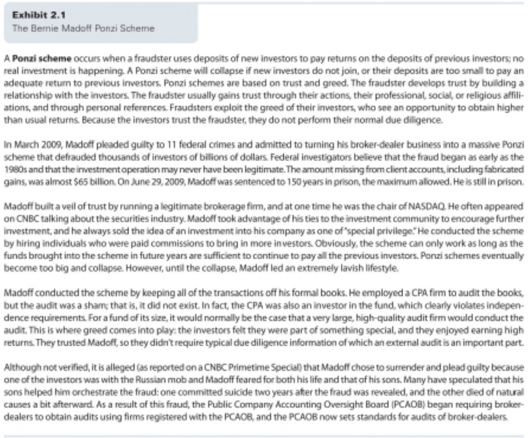


Exhibit 2.1
The Bernie Madoff Ponzi Scheme

A **Ponzi scheme** occurs when a fraudster uses deposits of new investors to pay returns on the deposits of previous investors; no real investment is happening. A Ponzi scheme will collapse if new investors do not join, or their deposits are too small to pay an adequate return to previous investors. Ponzi schemes are based on trust and greed. The fraudster develops trust by building a relationship with the investors. The fraudster usually gains trust through their actions, their professional, social, or religious affiliations, and through personal references. Fraudsters exploit the greed of their investors, who see an opportunity to obtain higher than usual returns. Because the investors trust the fraudster, they do not perform their normal due diligence.

In March 2009, Madoff pleaded guilty to 11 federal crimes and admitted to turning his broker-dealer business into a massive Ponzi scheme that defrauded thousands of investors of billions of dollars. Federal investigators believe that the fraud began as early as the 1980s and that the investment operation may never have been legitimate. The amount missing from client accounts, including fabricated gains, was almost $65 billion. On June 29, 2009, Madoff was sentenced to 150 years in prison, the maximum allowed. He is still in prison.

Madoff built a veil of trust by running a legitimate brokerage firm, and at one time he was the chair of NASDAQ. He often appeared on CNBC talking about the securities industry. Madoff took advantage of his ties to the investment community to encourage further investment, and he always sold the idea of an investment into his company as one of "special privilege." He conducted the scheme by hiring individuals who were paid commissions to bring in more investors. Obviously, the scheme can only work as long as the funds brought into the scheme in future years are sufficient to continue to pay all the previous investors. Ponzi schemes eventually become too big and collapse. However, until the collapse, Madoff led an extremely lavish lifestyle.

Madoff conducted the scheme by keeping all of the transactions off his formal books. He employed a CPA firm to audit the books, but the audit was a sham; that is, it did not exist. In fact, the CPA was also an investor in the fund, which clearly violates independence requirements. For a fund of its size, it would normally be the case that a very large, high-quality audit firm would conduct the audit. This is where greed comes into play: the investors felt they were part of something special, and they enjoyed earning high returns. They trusted Madoff, so they didn't require typical due diligence information of which an external audit is an important part.

Although not verified, it is alleged (as reported on a CNBC Primetime Special) that Madoff chose to surrender and plead guilty because one of the investors was with the Russian mob and Madoff feared for both his life and that of his sons. Many have speculated that his sons helped him orchestrate the fraud: one committed suicide two years after the fraud was revealed, and the other died of natural causes a bit afterward. As a result of this fraud, the Public Company Accounting Oversight Board (PCAOB) began requiring broker-dealers to obtain audits using firms registered with the PCAOB, and the PCAOB now sets standards for audits of broker-dealers.

Fraudulent Financial Reporting

- The intentional manipulation of reported financial results is called fraudulent financial reporting
- Motivations
  - Perpetrator seeks gain through the rise in stock price and the commensurate increase in personal wealth
  - Perpetrator tries to “help” the organization avoid bankruptcy or other negative financial outcome

Common Means to Accomplish Fraudulent Financial Reporting

- Manipulation, falsification, or alteration of accounting records or supporting documents
- Misrepresentation or omission of events, transactions, or other significant information
- Intentional misapplication of accounting principles

Check Your Basic Knowledge—True/False

2-1 The Great Salad Oil Swindle of 1963 is an asset misappropriation fraud. (T/F)

2-2 The Koss Corporation fraud is a fraudulent financial reporting fraud. (T/F)

Check Your Basic Knowledge (2-3)

2-3 What is the primary difference between fraud and error in financial statement reporting?

a. The materiality of the misstatement.

b. The intent to deceive.

c. The level of management involved.

d. The type of transaction effected.

Check Your Basic Knowledge (2-4)

2-4 Which of the following examples best represents an example of fraudulent financial reporting?

a. The transfer agent issues 40,000 shares of the company's stock to a friend without authorization by the board of directors.
b. The controller of the company inappropriately records January sales in December so that year-end results will meet analysts' expectations.
c. The in-house attorney receives payments from the French government for negotiating the development of a new plant in Paris.
d. The accounts receivable clerk covers up the theft of cash receipts by writing off older receivables without authorization.

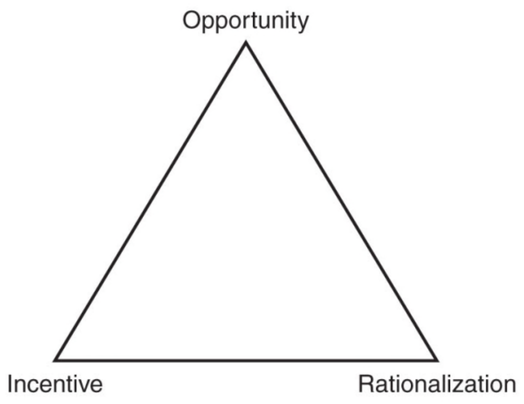
What Do You Think? (p. 60)

- Given that many frauds ultimately are discovered, and that there exists very significant negative consequences to the fraudsters themselves, in addition to their victims, why do you think that both theft and financial reporting fraud continue to be prevalent in our society?

The Fraud Triangle

- The three elements of the fraud triangle include
  - An incentive to commit fraud
  - The opportunity to commit and conceal the fraud
  - Rationalization—the mindset of the fraudster to justify committing the fraud

Exhibit 2.2
The Fraud Triangle



Incentives or Pressures to Commit Fraud

- Possible incentives for fraudulent financial reporting include:
  - Management compensation schemes
  - Financial pressures for either improved earnings or an improved balance sheet
  - Debt covenants

Opportunities to Commit Fraud

- Lack of controls
- Complex transactions
- Significant related-party transactions
- A company’s industry position
- Management’s inconsistency involving subjective judgments regarding assets or accounting estimates

Rationalizing the Fraud

- Rationalization can range from “saving the company” to personal greed
- Examples of rationalization
  - This is a one-time thing to get us through the current crisis and survive until things get better
  - Everybody cheats on the financial statements a little; we are just playing the same game
  - We will be in violation of all of our debt covenants unless we find a way to get this debt off the financial statements
  - I will lose everything (family, home, car, and so on) if I don’t take the money

Check Your Basic Knowledge—True/False

2-5 The three elements of the fraud triangle include incentive, opportunity, and rationalization. (T/F)

2-6 Management compensation schemes that heavily emphasize stock-based compensation primarily affect the opportunity to commit fraud. (T/F)

Check Your Basic Knowledge (2-7)

2-7 Which of the following factors creates an opportunity for fraud to be committed in an organization?

a. Management demands financial success.

b. Poor internal control.

c. Commitments tied to debt covenants.

d. Management is aggressive in its application of accounting rules.

Check Your Basic Knowledge (2-8)

2-8 Which of the following is a common rationalization for fraudulent financial reporting?

a. This is a one-time transaction and it will allow the company to get through the current financial crisis, but I'll never do it again.
b. I am only borrowing the money; I will pay it back next year.
c. Executives at other companies are getting paid more than I am, so I deserve the money.
d. The accounting rules don't make sense for our company, and they make our financial results look weaker than is necessary. Therefore, we have good reason to record revenue using a non-GAAP method.
e. Both (a) and (d).

What Do You Think? (p. 64)

- The three elements of the fraud triangle include incentive, opportunity, and rationalization.
  - Are each alone significant enough to enable the fraudster to perpetrate the fraud?
  - If you had to rank the three in terms of importance, what would that ranking be, and what is your rationale for that ranking?

History of Fraudulent Financial Reporting

- More than 20 notable instances of fraudulent financial reporting occurred over the last two decades
- The patterns evident across the frauds implications for auditors

Exhibit 2.3

- Refer to Exhibit 2.3 for summaries of fraudulent financial reporting involving:
  - Enron
  - WorldCom
  - Parmalat
  - HealthSouth
  - Dell
  - Koss Corp.
  - Olympus
  - Longtop Financial Technologies
  - Peregrine Financial Group
  - Sino-Forest Corporation
  - Diamond Foods, Inc.
  - Wells Fargo
  - Weatherford Int'l
  - Lime Energy Company

Exhibit 2.3
Important Cases of Fraudulent Financial Reporting

Company	Nature of the Fraud
Enron (2001)	Considered by many to be one of the most significant frauds of the early 2000s, Enron was initially a utility company that management converted into an energy trading company. When energy trades went bad, management covered up financial problems by: • Shifting debt to off–balance sheet special entities • Recognizing revenue on impaired assets by selling them to special-purpose entities that they controlled • Engaging in round-tripping trades, which are trades that eventually found the assets returning to Enron after initially recognizing sales and profits • Numerous other related-party transactions
WorldCom (2002)	In what would end in one of the largest bankruptcies of all time, WorldCom was the second-largest U.S. long-distance phone company (after AT&T). The company pursued an aggressive growth strategy of acquiring other telecommunications companies. When the financial results of these acquisitions faltered, management decreased expenses and increased revenues through the following: • Recording bartered transactions as sales; for example, trading the right to use lines in one part of the world to similar rights to another part of the world • Using restructuring reserves established through acquisitions to decrease expenses; for example, over-accruing reserves upon acquiring a company and later "releasing" those reserves to decrease expenses of future periods • Capitalizing line costs (rentals paid to other phone companies) rather than expensing them as would have been appropriate
Parmalat (2003)	Parmalat is an Italian multinational company specializing in milk, fruit juice, and other food products. In the late 1990s, the company acquired various international subsidiaries and funded the acquisitions with debt. Ultimately, the fraud led to the largest bankruptcy in Europe. The company siphoned cash from subsidiaries through a complex scheme that: • Overstated cash and included the false recording of cash ostensibly held at major banks • Understated debt by entering into complex transactions with off-shore subsidiaries in tax-haven places such as countries in the Caribbean
HealthSouth (2003)	HealthSouth runs the largest group of inpatient rehabilitation hospitals in the United States. Top management directed company employees to grossly exaggerate earnings in order to meet shareholder and analyst expectations. A wide variety of schemes were used, including: • Billing group psychiatric sessions as individual sessions; for example, with ten people in a group session, billing for ten individual sessions instead of one group session • Using adjusted journal entries to both reduce expenses and enhance revenues
Dell (2005)	Dell is a U.S. computer maker that ultimately was forced to pay the SEC $100 million to settle fraud charges against the company. The fraud included various disclosure inaccuracies, including: • Misleading investors by miscategorizing large payments from Intel, which were essentially bribes to ensure that Dell would not use central processing units manufactured by Intel's main rival • Misrepresenting the Intel payments as involving operations, thereby enabling the company to meet its earnings targets • Failing to disclose the true reason for the company's profitability declines that occurred after Intel refused to continue making the payments
Koss Corp. (2009)	Koss Corporation is a U.S. headphone manufacturer. The CFO misappropriated approximately $31 million of funds for her personal use during a period of time in which reported earnings was $26 million. Ultimately, she had to pay $34 million in restitution and was given an eleven-year prison sentence. She perpetrated the fraud through a process consisting of: • Intimidation of lower-level employees • Sole approval for large expenditures made through American Express and other corporate credit cards • Lack of supervisory review and approval by the CEO • Lack of audit committee oversight • Lack of an effective internal audit function

Implications for External Auditors

- The auditor should be aware of the pressure that analyst following and earnings expectations create for top management
- If there are potential problems with revenue, the auditor cannot complete the audit until there is sufficient time to examine major year-end transactions
- The auditor must understand complex transactions to determine their economic substance and the parties that have economic obligations
- The auditor must clearly understand and analyze weaknesses in an organization's internal controls in order to determine where and how a fraud may take place
- The auditor must develop audit procedures to address specific opportunities for fraud to take place

Insights from COSO Studies

- The Committee of Sponsoring Organizations (COSO) has published several studies on fraudulent financial reporting
- These studies provide insights based on companies that have been cited in an SEC Accounting and Auditing Enforcement Release (AAER)

Insights from COSO Studies—Major Findings

- Total amount of fraud during the 1998–2007 was more than $120 billion spread across just 300 companies
- Median size of the company perpetrating the fraud rose tenfold to $100 million during the 1998–2007 period (as compared to the previous ten years)
- Heavy involvement in the fraud by the CEO and/or CFO
- Most common fraud involved revenue recognition
- One-third of the companies changed auditors during the latter part of the fraud
- Majority of the frauds took place at companies that were listed on the over-the-counter (OTC) market, rather than those listed on the NYSE or NASDAQ

Insights from COSO Studies—Commonly Cited Motivations

- Need to meet internal or external earnings expectations
- Attempt to conceal the company's deteriorating financial condition
- Need to increase the stock price
- Need to bolster financial performance for pending equity or debt financing
- Desire to increase management compensation based on financial results

The Enron Fraud

- How did it happen?
- Concept
- Compensation
- Widespread fraud

Failures that Allowed the Enron Fraud to Occur

- Management accountability
- Corporate governance
- Accounting rules
- The financial analyst community
- Banking and investment banking
- The external auditing profession and Arthur Andersen

What Do You Think? (p. 69)

- After reading these various descriptions and definitions of professional skepticism, consider someone in your life that you view as particularly skeptical.
  - Who is that person?
  - How do you know him or her?
  - What characteristics does he or she possess that influence your view about his or her relative skepticism?
  - What factors in his or her life and experiences do you think made that person particularly skeptical?
  - Do you think that you could exhibit professional skepticism when conducting an audit?

What Do You Think? (p. 70)

- An example of a current SEC AAER can be found at:
  https://www .sec.gov/litigation/admin/2017/33-10286.pdf
- Read the AAER and consider the following questions:
  (1) What is the company involved in the fraud and what is their line of business?
  (2) What was the nature of the fraud?
  (3) How did the fraud come to light? Who was the person that led to its discovery?
  (4) It does not appear that the audit firm was charged in this case, but the company and its CFO, Myles Itkin, were charged. Why do you think the auditing firm avoided SEC punishment for failing to detect the fraud in a timely manner?
- If you are curious and want to challenge yourself, locate other recent AAERs on the SEC's website.
  - Go to: www.sec.gov
  - Click on the Enforcement link
  - Click on the Accounting and Auditing link
  - Click on any current or prior year to retrieve the AAERs

Check Your Basic Knowledge—True/False

2-9 In the Enron fraud, one of the ways that management covered up the fraud was to shift debt off the balance sheet to SPEs. (T/F)

2-10 Professional skepticism related to detecting possible fraud involves the validation of information through probing questions, critical assessment of evidence, and attention to inconsistencies. (T/F)

Check Your Basic Knowledge (2-11)

2-11 Which of the following types of transactions did WorldCom management engage in as part of that company's fraudulent financial reporting scheme?

a. Recorded barter transactions as sales.

b. Used restructuring reserves from prior acquisitions to decrease expenses.

c. Capitalizing line costs rather than expensing them.

d. All of the above.

e. None of the above.

Check Your Basic Knowledge (2-12)

2-12 Which of the following is an implication resulting from the results of the COSO studies?

a. The most common frauds involve outright theft of assets.

b. The individuals most often responsible for fraud include low-level accounting personnel, such as accounts payable clerks.

c. The majority of frauds take place at smaller companies listed on the OTC market rather than at larger companies listed on the NYSE.

d. All of the above.

e. None of the above.

Fraud: Auditors' Responsibilities and Users' Expectations

- Management, the audit committee, internal auditors, external auditors and regulatory authorities need to:
  - Acknowledge need for a strong, highly ethical tone at the top of an organization that permeates the corporate culture, including an effective fraud risk management program
  - Exercise professional skepticism in evaluating and/or preparing financial reports
  - Remember that strong communication among those involved in the financial reporting process is critical

Fraud-Related Requirements in Professional Auditing Standards

- Professional auditing standards require the auditor to plan and perform an audit that will detect material misstatements resulting from fraud.

Exhibit 2.4

- Refer to Exhibit 2.4 for details on professional auditing standards
  - Column 1 identifies the Considerations Regarding Fraud
  - Column 2 provides details about PCAOB AS 2401
  - Column 3 provides details about AICPA AU-C 240 and IAASB ISA 240

Exhibit 2.4
Professional Standards on Audit Considerations Regarding Fraud

Considerations Regarding Fraud	PCAOB AS 2401	AICPA AU-C 240 and IAASB ISA 240
Management's responsibilities	Management is responsible for designing and implementing programs and controls to prevent, deter, and detect fraud.	The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.
The auditor's responsibilities	The auditor is responsible for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. The standard acknowledges that there is an unavoidable risk that some material misstatements may be undetected, even if the audit is properly planned and performed.	The auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free of material misstatement, whether caused by error or fraud. The standard acknowledges that there is an unavoidable risk that some material misstatements may be undetected, even if the audit is properly planned and performed.
Professional skepticism	Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest.	The auditor should maintain professional skepticism, regardless of the auditor's past experience with honesty and integrity of management and those charged with governance. The auditor should investigate when management or those charged with governance provide unsatisfactory responses (e.g., inconsistent, vague, or implausible) to questions. The auditor may accept records and documents as genuine but should investigate if the auditor believes that such an assumption is not appropriate.
Risk assessment	The auditor should formally assess fraud risk through a discussion among the engagement team members (commonly referred to as **fraud brainstorming**). The auditor should identify unusual or unexpected relationships in performing analytical procedures that might indicate fraud.	The auditor should formally assess fraud risk through a discussion among the engagement team members (commonly referred to as *fraud brainstorming*). The auditor should identify unusual or unexpected relationships in performing analytical procedures that might indicate fraud.
Risk response	The auditor must respond to identified fraud risks. Responses should include ensuring that audit personnel are adequately trained and supervised, evaluating whether subjective or complex transactions may indicate fraud, and incorporating an element of unpredictability in the nature, timing, and extent of audit procedures.	The auditor must respond to identified fraud risks. Responses should include ensuring that audit personnel are adequately trained and supervised, evaluating whether subjective or complex transactions may indicate fraud, and incorporating an element of unpredictability in the nature, timing, and extent of audit procedures.

Check Your Basic Knowledge—True/False

2-13 The investing public generally recognizes that it is very difficult for auditors to detect fraud, so investors do not hold auditors accountable when auditors fail to detect fraud. (T/F)

2-14 The mission of the SEC is to restore the confidence of investors, and society generally, in the independent auditors of companies. (T/F)

Check Your Basic Knowledge (2-15)

2-15 Which of the following statements is true regarding the deterrence and detection of fraud in financial reporting?

a. Preventing and detecting fraud is the job of the external auditor alone.
b. An effective fraud risk management program can be expected to prevent virtually all frauds, especially those perpetrated by top management.
c. Communication among those involved in the financial reporting process is critical.
d. All of the above.
e. None of the above.

Check Your Basic Knowledge (2-16)

2-16 Which of the following statements is true?

a. Unless an independent audit can provide reasonable assurance that financial information has not been materially misstated because of fraud, it has little, if any, value to society.

b. Repeated revelations of accounting scandals and audit failures related to undetected frauds have seriously damaged public confidence in external auditors.

c. A strong ethical tone at the top of an organization that permeates corporate culture is essential in mitigating the risk of fraud.

d. All of the above.

e. None of the above.

What Do You Think? (p. 74)

- Auditors are held accountable for their ability to detect fraud, facing severe consequences sometimes for not detecting fraud.
  - However, management may collude, lie to the auditors, and cover up a fraud.
  - Do you think the auditors' negative consequences, both in monetary and reputation terms, are unfair as a result?

The Sarbanes-Oxley Act of 2002 as a Regulatory Response to Fraud

- Financial scandals and associated stock market declines in the early 2000s
  - Bad ethical decisions
  - Weak corporate governance
  - Low audit quality
  - Insufficient auditor independence
- Response to Enron bankruptcy and collapse of Arthur Andersen
- Sarbanes-Oxley only applies to publicly traded companies

Significant Audit-Related Provisions of the Sarbanes-Oxley Act of 2002

- Title I removes self-regulation of the auditing profession and replaces it with independent oversight by the PCAOB
- Section 201 prevents audit firms from providing many consulting services to audit clients
- Sections 204, 301, and 407 significantly expand the power, responsibilities, and disclosures of corporate audit committees
- Section 404 requires management assessment and external audit firm attestation regarding the effectiveness of internal control over financial reporting
- Refer to Exhibit 2.5 for a list of significant audit-related provisions

Exhibit 2.5

- Refer to Exhibit 2.5 for a list of significant audit-related provisions

Exhibit 2.5
Significant Audit-Related Provisions of the Sarbanes-Oxley Act of 2002

TITLE I: Public Company Accounting Oversight Board

101 *Establishment and administrative provisions.* The Board:
- Is a nonprofit corporation, not an agency of the U.S. government
- Will have five financially literate members who are prominent individuals of integrity and reputation with a commitment to the interests of investors and the public
- Has authority to set standards related to audit reports and to conduct inspections of registered public accounting firms

102 *Registration with the Board.* Accounting firms auditing public companies must register with the PCAOB.

103 *Auditing, quality control, and independence standards and rules.* The Board will:
- Establish or adopt rules regarding the conduct of audits and regarding audit firm quality-control standards
- Require audit firms to describe the scope of testing of issuers' internal control structure

104 *Inspections of registered public accounting firms.* The Board will:
- Inspect annually registered accounting firms that audit 100 or more issuers
- Inspect at least every three years registered accounting firms that audit fewer than 100 issuers
- Publicly report results of its inspections

105 *Investigations and disciplinary proceedings.* The Board will:
- Adopt procedures for disciplining registered accounting firms
- Require registered accounting firms to provide documentation and testimony that the Board deems necessary to conduct investigations
- Be able to sanction registered accounting firms for noncooperation with investigations

106 *Foreign public accounting firms.* Foreign accounting firms must comply with the same rules related to the PCAOB as domestic accounting firms.

107 *Commission oversight of the Board.* The SEC has oversight and enforcement authority over the Board, including in processes involving standards setting, enforcement, and disciplinary procedures.

108 *Accounting standards.* The SEC will recognize as "generally accepted" accounting principles that are established by a standard setter that meets the Act's criteria.

109 *Funding.* Registered accounting firms and issuers will pay for the operations of the Board.

TITLE II: Auditor Independence

201 *Services outside the scope of practice of auditors.* There are a variety of services that registered accounting firms may not perform for issuers, such as bookkeeping, systems design, appraisal services, and internal auditing, among others. Tax services may be performed, but only with preapproval by the audit committee.

202 *Preapproval requirements.* All audit and nonaudit services (with certain exceptions based on size and practicality) must be approved by the audit committee of the issuer.

203 *Audit partner rotation.* The lead partner and reviewing partner must rotate off the issuer engagement at least every five years.

204 *Auditor reports to audit committees.* Registered accounting firms must report to the audit committee issues concerning:
- Critical accounting policies and practices
- Alternative treatments of financial information within generally accepted accounting principles that have been considered by management, as well as the preferred treatment of the accounting firm
- Significant written communications between the accounting firm and management

205 *Conforming amendments.* This section details minor wording changes between the Sarbanes-Oxley Act and the Securities Act of 1934.

206 *Conflicts of interest.* Registered accounting firms may not perform audits for an issuer whose CEO, CFO, controller, chief accounting officer, or other equivalent position was employed by the accounting firm during the one-year period preceding the audit. This is known as a **cooling-off period**.

207 *Study of mandatory rotation of registered public accounting firms.* The Comptroller General of the United States shall conduct a study addressing this issue.

TITLE III: Corporate Responsibility

301 *Public company audit committees.*
- Audit committees are to be directly responsible for the appointment, compensation, and oversight of the work of registered accounting firms.
- Each audit committee member shall be independent.
- Audit committees must establish whistle-blowing mechanisms within issuers.
- Audit committees have the authority to engage their own independent counsel.
- Issuers must provide adequate funding for audit committees.

302 *Corporate responsibility for financial reports.* The signing officers (usually the CEO and CFO):
- Will certify in quarterly and annual reports filed with the SEC that the report does not contain untrue statements of material facts and that the financial statements and disclosures present fairly (in all material respects) the financial condition and results of operations of the issuer
- Must establish and maintain effective internal controls to ensure reliable financial statements and disclosures
- Are responsible for designing internal controls, assessing their effectiveness, and disclosing material deficiencies in controls to the audit committee and to the registered accounting firm

Exhibit 2.5 *Continues*

Exhibit 2.5 *Continued*

303 *Improper influence on conduct of audits.* Officers of issuers may not take action to fraudulently influence, coerce, manipulate, or mislead the registered accounting firm or its employees.

TITLE IV: Enhanced Financial Disclosures

401 *Disclosures in periodic reports.*
- Financial reports must be in accordance with generally accepted accounting principles and must reflect material correcting adjustments proposed by the registered accounting firm.
- Material off-balance sheet transactions and other relationships with unconsolidated entities or persons must be disclosed.
- The SEC must issue new rules on pro forma figures and must study the issues of off-balance sheet transactions and the use of SPEs.

402 *Enhanced conflict of interest provisions.* Issuers may not extend credit to directors or executive offers.

403 *Disclosures of transactions involving management and principal stockholders.* Requires that any director, officer, or shareholder who owns more than 10% of the company's equity securities publicly disclose that fact.

404 *Management assessment of internal controls.*
- Annual reports must state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting.
- Annual reports must contain an assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
- Each registered accounting firm must attest to and report on the assessment made by the management of the issuer, and such attestation must not be the subject of a separate engagement (in other words, requires an integrated audit).

406 *Code of ethics for senior financial officers.* The SEC must issue rules requiring issuers to disclose whether or not the issuer has adopted a code of ethics for senior financial officers (and if not, the issuer must explain the rationale).

407 *Disclosure of audit committee financial expert.* The SEC must issue rules to require issuers to disclose whether or not the audit committee of the issuer includes at least one member who is a financial expert (and if not, the issuer must explain the rationale).

Sarbanes-Oxley
TITLE I: Public Company Accounting Oversight Board

101 Establishment and administrative provisions

102 Registration with the Board

103 Auditing, quality control, and independence standards and rules

104 Inspections of registered public accounting firms

105 Investigations and disciplinary proceedings.

106 Foreign public accounting firms

107 Commission oversight of the Board

108 Accounting standards

109 Funding

Sarbanes-Oxley
TITLE II: Auditor Independence

201 Services outside the scope of practice of auditors

202 Preapproval requirements

203 Audit partner rotation

204 Auditor reports to audit committees

205 Conforming amendments

206 Conflicts of interest

207 Study of mandatory rotation of registered public accounting firms

Sarbanes-Oxley
TITLE III: Corporate Responsibility

301 Public company audit committees

302 Corporate responsibility for financial reports

303 Improper influence on conduct of audits

Sarbanes-Oxley
TITLE IV: Enhanced Financial Disclosures

401 Disclosures in periodic reports

402 Enhanced conflict of interest provisions

403 Disclosures of transactions involving management and principal stockholders

404 Management assessment of internal controls

406 Code of ethics for senior financial officers

407 Disclosure of audit committee financial expert

What Do You Think? (p. 76)

- Read the various sections of the Sarbanes-Oxley Act at:

  https://www.sec.gov/about/laws/soa2002.pdf

  - Which provisions strike you as the most important/influential in preventing potential fraud?
  - Which provisions surprise you or change your view of the auditing profession and regulation? Explain why.

Check Your Basic Knowledge—True/False

2-17 The AICPA wrote the Sarbanes-Oxley Act of 2002 to address problems revealed in frauds that were committed in the late 1980s. (T/F)

2-18 An important change resulting from the Sarbanes-Oxley Act is that auditors are no longer allowed to provide most consulting services for their public company audit clients. (T/F)

Check Your Basic Knowledge (2-19)

2-19 Refer to Exhibit 2.5. The Sarbanes-Oxley Act enacted which of the following provisions relevant to auditors and the audit opinion formulation process?

a. The PCAOB was established, and it has the power to conduct inspections of public company audits.

b. The lead audit partner and reviewing partner must rotate off the audit of a publicly traded company at least every 10 years.

c. In the annual report, management must acknowledge that they are required to have the company's internal audit function attest to the accuracy of the annual reports.

d. All of the above.

e. None of the above.

Check Your Basic Knowledge (2-20)

2-20 Which of the following statements is true regarding the PCAOB?

a. The PCAOB is a nonprofit corporation, not an agency of the U.S. government.

b. The PCAOB will have five financially literate members who are prominent individuals of integrity and reputation with a commitment to the interests of investors and the public.

c. The PCAOB has authority to set standards related to public company audit reports and to conduct inspections of registered external audit firms.

d. All of the above.

e. None of the above.

What Do You Think? (p. 77)

- One part of Section 302 of the Sarbanes-Oxley Act states that the CEO and CFO:

  Will certify in quarterly and annual reports filed with the SEC that the report does not contain untrue statements of material facts and that the financial statements and disclosures present fairly (in all material respects) the financial condition and results of operations of the issuer.

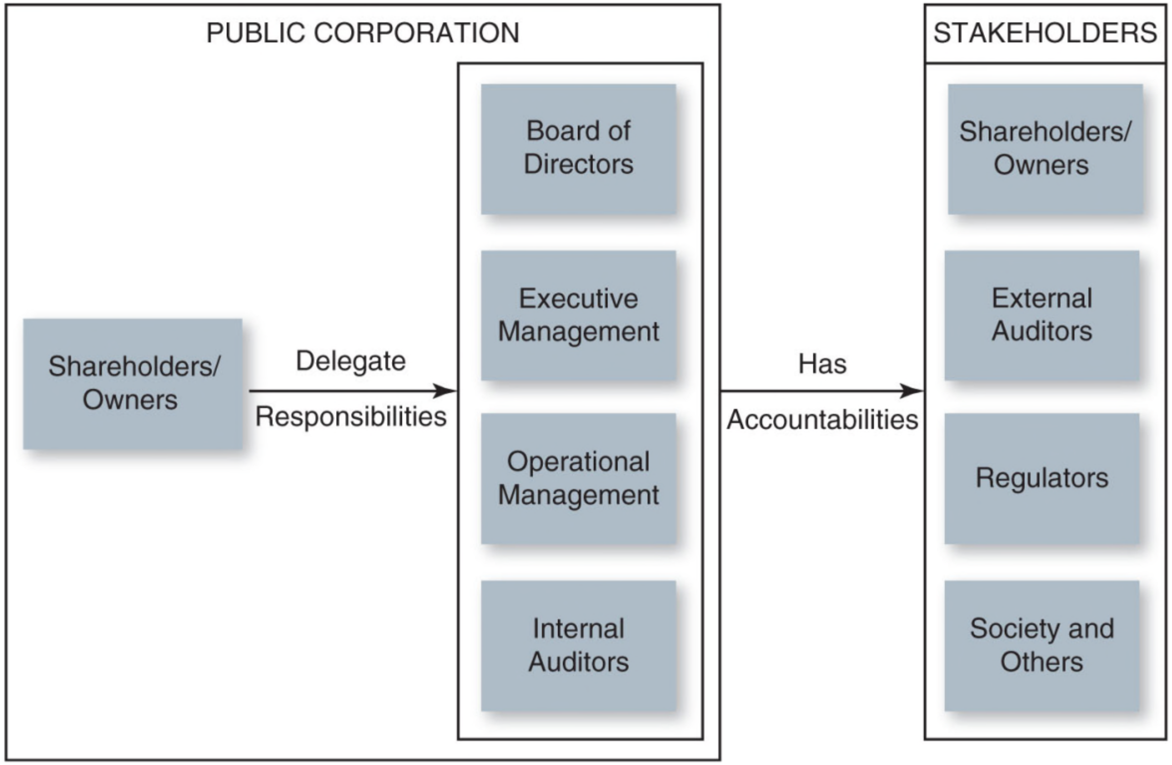
  - If top management is committing a fraud, do you think that they will refuse to certify the annual reports?
  - What do you think that they will do when faced with that requirement?

Corporate Governance Defined

- Corporate governance is a process by which the owners (stockholders) and creditors of an organization exert control and require accountability for the resources entrusted to the organization.
- The owners elect a board of directors to provide oversight of the organization's activities and accountability to stakeholders.

Exhibit 2.6

Exhibit 2.6
Overview of Corporate Governance Responsibilities and Accountabilities



Responsibility and Accountability

- Governance demands accountability back through the system to the owners and other stakeholders
  - Stakeholders include anyone who is affected, either directly or indirectly, by the actions of a company
- Management and the board have responsibilities to
  - Act within the laws of society
  - Meet various requirements of creditors and employees and other stakeholders
- Corporate governance mosaic refers to the complementary roles and specific responsibilities of the parties
- No one party is completely responsible

Exhibit 2.7

- Refer to Exhibit 2.7 for details

Exhibit 2.7
Corporate Governance Responsibilities

Party	Overview of Responsibilities
Stockholders	Provide effective oversight through election of board members, through approval of major initiatives (such as buying or selling stock), and through annual reports on management compensation from the board
Board of Directors	Serve as representatives of stockholders; ensure that the organization is run according to the organization's charter and that there is proper accountability **Specific activities include:** • Selecting management • Reviewing management performance and determining compensation • Declaring dividends • Approving major changes, such as mergers • Approving corporate strategy • Overseeing accountability activities
Management	Manage the organization effectively; provide accurate and timely accountability to shareholders and other stakeholders **Specific activities include:** • Formulating strategy and risk management • Implementing effective internal controls • Developing financial and other reports to meet public, stakeholder, and regulatory requirements • Managing and reviewing operations • Implementing an effective ethical environment
Audit Committees of the Board of Directors	Provide oversight of the internal and external audit function and over the process of preparing the annual financial statements and public reports on internal control **Specific activities include:** • Selecting the external audit firm • Approving any nonaudit work performed by the audit firm • Selecting and/or approving the appointment of the chief audit executive (internal auditor) • Reviewing and approving the scope and budget of the internal audit function • Discussing audit findings with internal and external auditors, and advising the board (and management) on specific actions that should be taken
Regulators and Standards Setters (PCAOB, SEC, AICPA, FASB, IAASB, IASB)	Set accounting and auditing standards dictating underlying financial reporting and auditing concepts; set the expectations of audit quality and accounting quality **Specific activities include:** • Establishing accounting principles • Establishing auditing standards • Interpreting previously issued standards • Enforcing adherence to relevant standards and rules for public companies and their auditors

What Do You Think? (p. 79)

- Consider the roles and responsibilities of each of these parties with corporate governance responsibilities.
  - Which party do you think is most responsible for preventing fraud?
  - Which party do you think is most responsible for detecting fraud?

Characteristics of Effective Corporate Governance

- In 2010, a commission sponsored by the NYSE issued a report identifying key core governance principles
- The report includes both broad principles related to boards and management, along with very specific corporate governance guidelines

Broad Principles of Effective Corporate Governance

- Long-term sustainable growth in shareholder value for the corporation
- Successful management of the company
  - Including creation of a culture of performance with integrity and ethical behavior
- Integration with the company’s business strategy
  - Not viewed as simply a compliance obligation
- Transparency
  - Regular efforts to ensure that they have sound disclosure policies and practices
- Independence and objectivity
  - Balance in the appointment of independent and non-independent directors
  - Appropriate range and mix of expertise, diversity, and knowledge on the board

NYSE Corporate Governance Guidelines

- Boards need to consist of a majority of independent directors
- Boards need to hold regular executive sessions of independent directors without management present
- Companies must adopt and disclose corporate governance guidelines addressing director qualification standards, director responsibilities, director access to management and independent advisors, director compensation, director continuing education, management succession, and an annual performance evaluation of the board
- Companies must adopt and disclose a code of business conduct and ethics for directors, officers, and employees
- Foreign companies must disclose how their corporate governance practices differ from those followed by domestic companies
- CEOs must provide an annual certification of compliance with corporate governance standards
- Companies must have an internal audit function, whether housed internally or outsourced

NYSE Corporate Governance Guidelines Related to a Nominating/Corporate Governance Committee

- Boards must have a nominating/corporate governance committee composed entirely of independent directors
- This committee must have a written charter that addresses the committee's purpose and responsibilities
- An annual performance evaluation of the committee is required

NYSE Corporate Governance Guidelines Related to a Compensation Committee

- Boards must have a compensation committee composed entirely of independent directors
- The compensation committee must have a written charter that addresses the committee's purpose and responsibilities, which must include (at a minimum) the responsibility to:
  - Review and approve corporate goals relevant to CEO compensation
  - Make recommendations to the board about non-CEO compensation and incentive-based compensation plans
  - Produce a report on executive compensation
- An annual performance evaluation of the committee is required

NYSE Corporate Governance Guidelines Related to an Audit Committee

- Boards must have an audit committee with a minimum of three independent members
- The audit committee must have a written charter that addresses the committee's purpose and responsibilities
- The committee must produce an audit committee report
- An annual performance evaluation of the committee is required

What Do You Think? (p. 81)

- In 2014, the New York Stock Exchange (NYSE) provided an updated report with further details on stakeholder perspectives about corporate governance, viewpoints on the composition and structure of the Board of Directors, key challenges for boards and management, shareholder activism, and international "hot button" issues.
- To access a complete copy of the report, go to:

  https://www.nyse.com/publicdocs/nyse/listing/ NYSE_Corporate_Governance_Guide.pdf
- An emerging trend in corporate governance and stock trading is the concept of shareholder activism.
  - After reading the Guide, define shareholder activism.
  - Why is it important?
  - Why do you think there exist more shareholder activists today as compared to in the past?

Responsibilities of Audit Committees

- Section 301 of the Sarbanes-Oxley Act outlines the responsibilities of audit committee members for publicly traded companies
- Responsible for the appointment, compensation, and oversight of the work of audit firms
- Must be independent
- Must establish whistle-blowing mechanisms
- Must have the authority to engage their own independent counsel
- Must provide adequate funding for audit committees

Specific Responsibilities of Audit Committees Mandated by the NYSE

- Obtaining an annual report by the external auditor that addresses the company's internal control procedures, any quality-control or regulatory problems, and any relationships that might threaten the independence of the external auditor
- Discussing the company's financial statements with management and the external auditor
- Discussing in its meetings the company's earnings press releases, as well as financial information and earnings guidance provided to analysts
- Discussing in its meetings policies with respect to risk assessment and risk management
- Meeting separately with management, internal auditors, and the external auditor on a periodic basis
- Reviewing with the external auditor any audit problems or difficulties that they have had with management
- Setting clear hiring policies for employees or former employees of the external auditor
- Reporting regularly to the board of directors

Additional Responsibilities of Audit Committees in Many Organizations

- In many organizations the audit committee has the authority to:
  - Hire and fire the head of the internal audit function
  - Set the budget for the internal audit activity
  - Review the internal audit plan
  - Discuss all significant internal audit results
- Other responsibilities might include:
  - Performing or supervising special investigations
  - Reviewing policies on sensitive payments
  - Coordinating periodic reviews of compliance with company policies such as corporate governance policies

What Do You Think? (p. 83, top)

- To view the full set of NYSE listing requirements for companies wishing to access this capital market, go to:

  http://nysemanual.nyse .com/LCM/

  - How many sections of requirements exist?
  - Why do you think there are so many specific requirements?
  - How do these requirements help companies that are seeking capital?
  - How do these requirements make it difficult for companies that are seeking capital?
- Note that requirement 103.01B states that a company must meet an “earnings test,” which requires that pre-tax earnings from continuing operations must total at least $100,000,000 in the aggregate for the last three fiscal years with a minimum of $25,000,000 in each of the most recent two fiscal years.
  - What are the implications of an earnings test in terms of companies’ access to capital on the NYSE?
  - How does an earnings test protect investors?
  - How does the existence of an earnings test provide an incentive for management to commit financial reporting fraud?

Check Your Basic Knowledge—True/False

2-21 Corporate governance is the process by which the owners and creditors of an organization exert control over and require accountability for the resources entrusted to the organization. (T/F)

2-22 The term corporate governance mosaic refers to the fact that each of the parties involved in corporate governance has complementary roles and specific responsibilities; no one party is completely responsible. (T/F)

Check Your Basic Knowledge (2-23)

2-23 Audit committee activities and responsibilities include which of the following?

a. Selecting the external audit firm.

b. Approving corporate strategy.

c. Reviewing management performance and determining compensation.

d. All of the above.

e. None of the above.

Check Your Basic Knowledge (2-24)

2-24 Which of the following audit committee responsibilities has the NYSE mandated?

a. Obtaining a report each year by the internal auditor that addresses the company's internal control procedures, any quality-control or regulatory problems, and any relationships that might threaten the independence of the internal auditor.

b. Discussing in its meetings the company's earnings press releases as well as financial information and earnings guidance provided to analysts.

c. Reviewing with the internal auditor any audit problems or difficulties that they have had with management.

d. All of the above.

e. None of the above.

What Do You Think? (p. 83, bottom)

- Audit committee members have significant responsibilities, and can be held responsible should they fail to execute those responsibilities. They also can be held responsible for making poor judgments and/or making bad decisions that negatively affect the company on whose board they serve.
- Go to the following link, which provides Ford Motor Company's 2017 Proxy Statement:

http://shareholder.ford.com/~/media/ Files/F/Ford-IR/annual-report/2017-proxy-statement.pdf

- Locate the information about the audit committee member in the proxy. To find it efficiently, search on the name of the Audit Committee Chair, Stephen Butler.
  - Who are Ford's four audit committee members?
  - Search for their bios. What are their backgrounds? What are their responsibilities?
  - Locate their compensation information.
  - Notice that the Chairman of the Audit Committee makes $125,000 in cash alone for serving in that role. Do you think that compensation is sufficient or excessive?