Solutions for Chapter 2

Corporate Governance and Auditing Standards

Review Questions:

2-1. An audit committee is a subcommittee of the board of directors that is composed of independent, outside directors. The audit committee has oversight responsibility (on behalf of the full board of directors and its stockholders) for the outside reporting of the company (including annual financial statements); risk monitoring and control processes; and both internal and external audit functions.

2-2. An outside director is not a member of management, legal counsel, a major vendor, outside service provider, former employee, or others who may have a personal relationship with management that might impair their objectivity or independence.

The audit committee is responsible for assessing the independence of the external auditor and engage only auditors it believes are independent. Auditors are now hired and fired by audit committee members, not management. The intent is to make auditor accountability more congruent with stockholder and third-party needs.

2-3. The primary point of this question is for students to understand that the audit committee's role is one of oversight rather than direct responsibility. For example, management is responsible for the fairness of the financial statements. Auditors are responsible for their audit and independent assessment of financial reporting. The audit committee is not designed to replace the responsibility of either of these functions. The audit committee's oversight processes are to see that the management processes for financial reporting are adequate and the auditor's carry out their responsibilities in an independent and competent manner.

2-4. The audit committee has the ability to hire and fire both the internal auditor and the external auditor. However, in the case of the internal audit function, the audit committee has the ability to hire and fire the head of internal audit as well as set the audit plan and budget. The audit committee does not control regulatory auditors, but should meet with regulatory auditors to understand the scope of their work and to discuss audit findings with them.

2-5. A process by which the owners and creditors of an organization exert control and require accountability for the resources entrusted to the organization. The owner (stockholders) elect a board of directors to provide oversight of the organization's activities.

2-6. According to Mak Yuen Teen current definition of Corporate Governance lacks three crucial elements – having the right people, risk management and ethical behavior. He proposed a more appropriate way to define corporate governance: Corporate governance refers to having people with the character, competencies and commitment, supported by appropriate structures and processes, to direct and manage the company in an ethical manner. The objective of corporate governance is to enhance long term shareholder value through enhancing performance, accountability and risk management, while taking into account the interests of other stakeholders.

2-7. The International Auditing and Assurance Standards Board (IAASB) is an independent standard-setting body that serves the public interest by setting high-quality international standards for auditing, assurance, and other related standards, and by facilitating the convergence of international and national auditing and assurance standards. In doing so, the IAASB enhances the quality and consistency of practice throughout the world and strengthens public confidence in the global auditing and assurance profession.

2-8. Management is responsible for issued financial statements. Although other parties may be sued for what is contained in the statements, management is ultimately responsible. Ownership is important because it establishes responsibility and accountability. Management must set up and monitor financial reporting systems that help it meet its reporting obligations. It cannot delegate this responsibility to the auditors.

2-9. The audit committee has oversight responsibilities for both financial reporting and public reporting on internal accounting control. These responsibilities are exercised by:

- Requiring internal and external audit evaluation of internal controls,
- Assessing the quality of financial reporting processes,
- Inquiring of financial reporting decisions,
- Meeting periodically with the CFO, management, external auditors, and internal auditors.

2-10. Good governance is important to the external auditor for a number of reasons, including, but not limited to the following. Good governance

- usually leads to better corporate performance,
- reflects a commitment to a high level of ethics, integrity, and sets a strong tone for the organization's activities,
- requires a commitment to financial reporting competencies and to good internal controls,
- reduces the risks that the company will have materially misstated financial statements.

If a company has not committed to good governance processes, the auditor must seriously consider whether they should be associated with the client. As will be discussed more thoroughly in chapter 4, a company without good governance provides much greater risk to the auditor. Many audit firms are systematically eliminating high risk clients from their client portfolio.

2-11. The auditor might utilize the following procedures in determining the actual level of governance in an organization:

- observe the functioning of the audit committee by participating in the meetings, noting the quality of the audit committee questions and responses,

- observation and interaction with management regarding issues related to the audit, e.g.
  o providing requested information on a timely basis,

- o quality of financial personnel in making judgments,
  - o accounting choices that tend to 'push the limits' towards aggressiveness or creating additional reported net income,
  - o the quality of internal controls within the organization.
- review the minutes of the board of directors meetings to determine that they are consistent with good governance,
- review internal audit reports and especially determine the actions taken by management,
- review the compensation plan for top management,
- review management expense reimbursements to determine (a) completeness of documentation, (b) appropriateness of requested reimbursement, and (c) extent of such requests.
- review management's statements to the financial press to determine if they are consistent with the company's operations.

An audit program follows good corporate governance in the following way: Good governance is critical to the development of sound controls in an organization. The stronger the controls, the less risk the financial statements will be misstated.

The development of audit programs follow the standards in determining that sufficient evidence is gathered in order to evaluate the assertions being addressed in the audit engagement. Further, the gathering and evaluation of that evidence must be done by auditors who are independent of the client – in both fact and in appearance. Finally, the work must be carried out by auditors that understand the standards and exercise due professional care in the conduct of the audit engagement.

2-12. The major planning steps are:

- Meeting with the audit client
- Developing an understanding of the industry
- Develop an understanding of the client's financial reporting processes and controls
- Develop an understanding of materiality
- Develop a preliminary audit program that identifies the audit objectives defined in chapter 1.

2-13. The auditor would take a statistical sample of all additional to PP&E and verify the cost through reference to vendor invoices to determine that cost is accurately recorded and that title has passed to the company. If the company was considered high risk, the auditor might choose to physically verify the existence of the asset.

2-14. Audit procedures are designed to test the representations made in the financial statements. In other words, the financial statements contain assertions about the entity's assets,

liabilities, and income producing activities. For example, the account balance called inventory implies that the inventory that is represented by the dollar figures in the financial statements:

- exist,
- is owned by the company,
- is properly valued at the lower of cost or market, and at an acceptable methodology to compute cost,
- is all recorded in the correct period, and
- contains adequate disclosure about the nature and the pricing of the inventory.

2-15. Materiality is defined as the

> "magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

Materiality guidelines usually involve applying percentages to some base, such as total assets, total revenue, or pretax income. The base should be a "stable" account however, making total assets a better choice than pretax income.

Multiple Choice Questions:

2-16. d.
2-17. a.
2-18. a.
2-19. f.
2-20. d.
2-21. b.

Discussion and Research Questions:

2-22. *(Corporate Governance)*

a. The auditor might use the following approaches to determine whether a corporate code of ethics is actually followed:

- observe corporate behavior in tests performed during the audit, e.g. approaches the company takes to purchasing goods, promoting personnel, and so forth,
- observe criteria for promoting personnel; for example does performance always take on greater importance than how things are done,
- observe corporate plans to communicate the importance of ethical behavior, e.g. webcasts, emails, and so forth to communicate the importance of ethics,
- review activity on the client's whistleblowing website, or a summary of

whistleblowing activities reported by the internal auditor,

- read a sample of self-evaluations by corporate officers, the board, and the audit committee and compare with the auditor's observations of behavior,

- examine sales transactions made during the end of quarters to determine if the sales reflect 'performance goals' as opposed to the company's code of ethics.

b. Are auditors equipped to make subjective judgments? This should be a great discussion question because many young people are attracted to the accounting profession because there are rules and relative certainty as to how things are done. However, as the profession is evolving, more judgments are required in both auditing and accounting. Audit personnel need to be equipped to make judgments on whether the company's governance structure operates as intended and whether there are deficiencies in internal control when it does not operate effectively. The profession believes that auditors can make such judgments.

c. Auditor can assess the financial competence of the Audit Committee by gaining the information of its members and their financial competencies, the quality of internal control will also speak about the financial competencies of the Audit Committee. The scope and terms of references of Audit Committee will also throw light on its competencies. Audit engagement in a organisation with poor expertise of Audit Committee leads to high engagement risk as the internal controls may not be able to curb the usual risk areas, further there could be frequent disputes with Audit committee on application of accounting policies, in absence of audit committee expertise to understand the correct application of auditing standards.

d. Effective internal audit department ensures good internal controls and leads to less violation of good corporate governance. Internal audit department highlights the issues in corporate governance code and ensure that the same is followed.

2-23. *(Auditor Expectations)*

ab&c. **Cookie jar reserves** are essentially funds that companies have "stashed away" to use when times get tough. The rationale is that the reserves are then used to "smooth" earnings in the years when earnings needs a boost. "Smooth" earnings typically are looked upon more favorably by the stock market. An example of a cookie jar reserve would be over-estimating an allowance account, such as allowance for doubtful accounts. The allowance account is then written down (and into the income statement) in a bad year.

Auditors may have allowed cookie jar reserves because they are known to smooth earnings, and smooth earnings are rewarded by the market. On the flip side, fluctuating earnings are penalized, and present more risk to the company of bankruptcy or other problems.

The Sarbanes-Oxley Act addressed the issue by creating an oversight body, the PCAOB, but also addressed the issue in other ways. For example, Congress felt that creating more effective Boards would decrease the use of earnings

management.

Allowing improper revenue recognition is one thing that auditors may have done in their unwillingness to say “no” to clients. For example, companies shipped out goods to customers at the end of the year for deep discounts and allowed returns at the beginning of the next year. This practice is known as channel stuffing. Since the goods had a great chance of being returned, it would be improper to recognize all as revenue.

Again, auditors were unwilling to say “no” to clients or believe they are adding value for the clients. Greed is probably the reason here. If companies claim more revenue, their stock would grow in the short-term, making management richer, and making management more willing to give pay raises to their auditors.

With the establishment of stronger audit committees and certification of financial statements in the Sarbanes-Oxley Act, this kind of accounting trickery will certainly decrease.

Creative accounting for M&A included the use of the “pooling” method of accounting. Pooling allowed acquiring companies to value existing assets at historical costs and did not require the recognition of goodwill for the acquisition. Because true costs (values) were not shown on the financial statements, management was often encouraged to bid up prices for acquisitions with the result that many of them were not economic. The creative accounting also shielded the income statement from charges that would have otherwise hit income including: goodwill amortization, depreciation, and depletion expenses.

The auditor believes he/she is adding value to the client or just plain greed. These are similar to the reasons for pushing revenue recognition.

Discussion between an educated audit committee and auditor plus certification of financial statements required by Sarbanes-Oxley will certainly address this issue.

Assisting management to meet earnings: Too often, auditors confused ‘financial engineering’ with value-adding. In other words, auditors often sought to add value to their clients by finding ways to push accounting to achieve earnings objectives sought by management. These earnings objectives then played a major role in escalating stock prices – all desired because of the heavy emphasis of management compensation on stock options.

Misalignment of Management Incentives: Incentives were misaligned. Most of management compensation came in the form of stock options which provided motivation to misstate earnings to boost stock prices.

The Sarbanes-Oxley Act of 2002 requires more financially literate and independent audit committees, increased auditor responsibility for reporting on internal control, the identification of users as the client of the auditor, and management certification of both financial statements and reports on internal control. All of these factors address the problems first identified by Arthur Levitt.

2-24. *(Audit Committees and Auditor Independence)*

a. This is intended to be an open-ended discussion. There are a number of factors that have been mentioned in the discussions regarding auditor independence. The following is representative of some issues discussed:

- The audit firm's policy for rotating auditors in charge of the engagement,

- Whether or not the client has hired personnel from the audit firm for significant financial or management positions in the company, such as the Chief Financial Officer was the former partner in charge of the audit engagement,

- The nature of non-audit services provided by the audit firm,

- The existence of any social or other relationships with management,

- Audit committee experience with the audit firm in other situations, such as the auditor provides services for other entities with which the audit committee member has an association,

- The existence of any charges brought against the auditing firm by the SEC,
- The audit firm's involvement in significant lawsuits where their judgment has been questioned,
- The amount of fees charged by the auditing firm. If the audit fees are too low, the audit committee should question the thoroughness and independence of the work. If fees from non-audit work are high, the audit committee will want to question that relationship and possible effect on judgments made by the auditor.
- The manner in which individual audit partners are compensated by the public accounting firm. For example, if an audit partner's compensation is determined significantly by whether or not a client is retained, then there might be questions about what the auditor would do to retain the client.
- The general reputation of the firm.
- The firm's policies and procedures for attracting and retaining talented audit personnel.
- The process of assigning personnel to an audit.
- The firm's expertise in the industry.

b. The main way that the audit committee can influence the independence of the internal audit department is by choosing who is in charge of the department. The "tone at the top" in the internal audit department will go a long way. Further, the audit committee ought to approve the scope of the internal audit charter, approve annual audit plans, as well as annual budgets.

c. 1. **Tax Return for Company:** *Approval argument*. The auditor is already aware of all the information, so can efficiently prepare the return. Tax accounting is different than audit accounting, so accounting treatments can be different in both settings and will not affect each other. Such an approval must require the audit committee's approval, thus there is effective oversight of the independence of the auditor in

preparing the tax return.

Non-Approval: On the other hand, some argue that tax preparation is a consulting activity, i.e. the auditor would need to be a client advocate and thereby should not prepare the tax return.

2. **Tax Return for Management and Board Members:** *Approval:* The auditor is an expert. The services can be viewed as a benefit or management and the board.

Not Approve: Performance of the tax services too closely aligns the auditor with management and the board. The auditor has to be a client advocate in developing the tax returns. This may mentally conflict with the auditor's need to be objective in all other work involving the client.

3. **Tax Return paid for by Managers, not company:** *Approval:* This is an independent service not paid for by the company.

Not Approve: The argument is the same as #2 above. Although paid for by the individuals, there is still the possibility of conflict.

4. Overseas Assistance for Internal Audit Department: *Do not approve*. It is the responsibility of management to prepare a review of internal control, and the auditor does an independent analysis. Further, the performance of internal audit work is one of the areas that have been explicitly prohibited by the SEC.

5. Security Audit of Information Systems: *Approve*. This is an assurance service in an area in which the auditor has competence. The work also provides information that is useful to the auditor in reporting on the financial statements.

Not Approve: There are two reasons to not approve the service.

First, there could be a perception on the part of some that the service is more a consulting service rather than an assurance service. However, both the auditor and the audit committee can protect against this by confining the engagement to the security audit.

Second, there could be a potential problem if management uses the auditor's evaluation as a major part of their assessment of internal controls over financial reporting. Since they are using the auditor's work as a basis for forming part of their opinion, the auditor could be perceived as auditing his or her own work.

6. Train Operating Personnel on Internal Controls: *Approve*. Auditors are experts on this area. There is no direct conflict with the performance of the audit. Better trained personnel should imply better internal controls – beneficial for both management and the auditor.

Not Approve. The management has the responsibility to design, implement, and evaluate internal control. Thus, training personnel is a management task that cannot be performed by the auditor. It could, however, be performed by a different public accounting firm.

7. **Perform Internal Audit Work for the Company:** *Do not approve*. It is the responsibility of management to prepare a review of internal control, and the auditor does an independent analysis. Usually internal audit is responsible for "management's" end of assessing internal controls.

2-25. *(Audit Committees)*

a. An **audit committee** is a subcommittee of the board of directors; it is responsible for monitoring audit activities and serves as a surrogate for the interests of shareholders. Audit committees should preferably be composed of outside members of the board, that is, members who do not hold company management positions or are closely associated with management.

b. The following information should be discussed with the audit committee:

- A summary of the auditor's responsibilities under Accounting Standards. Auditor responsibilities change over time as new standards are issued. The audit committee should always be aware of the nature of the audit function within the organization.

- Initial selection or major changes in *significant accounting policies* that could have a material affect on financial statement presentation. The audit committee needs to know how the choice may affect both current reports and future financial reports as well as the rationale for the choice because it is presumed that companies select the accounting principles that best reflect the economic substance of their transactions and are thus changed only when dictated by standard-setting bodies or when the economics of the situation change.

- The process utilized by management to make *significant estimates* and other management judgments such as loan loss reserves in banks and savings and loans and insurance reserves in insurance companies.

- *Significant audit adjustments* that may reflect on the stewardship and accountability of management, even if management agreed to make the adjustments.

- The auditor's review of and responsibility for *other information* contained in an annual report (outside of the audited financial statements).

- All major *accounting disagreements with management,* even if such disagreements are eventually resolved to the auditor's satisfaction.

- The auditor's knowledge of *management's consultation with other auditors* regarding accounting or auditing issues.
- Any significant accounting or auditing *issues discussed with management prior to the acceptance of the audit engagement* - in particular, any positions taken regarding the proper accounting of controversial areas should be disclosed.

- Any *difficulties encountered* in performing the audit, especially any activities undertaken by management that might be considered an impairment of the audit function.

- *Internal audit plans and reports* and management's responses to those reports.
- The extent to which the client has implemented a comprehensive *plan of risk assessment* and the organization's plans to mitigate, share, control, or otherwise address those risks.

- Any known *internal control weaknesses* that could significantly affect the financial reporting process.

The rationale for this communication is that the board of directors through its audit committee is responsible for the client's financial reporting and a thorough discussion of these issues will help them fulfill that responsibility.

2-26. *(Materiality)*

a. Materiality is defined as the

"magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

b. In the past when audit committees were not independent, materiality would not normally been discussed with audit committees or management. Now, materiality should be discussed with the audit committee to determine what an appropriate level of materiality might be for that audit. The audit committee can help to determine stakeholders and their decision-making criteria.

Some argue that management should be unaware of materiality. If management knew the amount, they might feel free to misstate up to that level in many different accounts, which could add up to a significant number (and fraud). Management would also have the ability to focus on only having good control of high dollar transactions, possibly compromising control over smaller transactions which can add up in a hurry. With this in mind, the SEC has put the audit profession on alert for offsetting material misstatements, swings in accounting estimates, or consistent immaterial adjustments.

That said, materiality is a guideline that is well understood in the profession. As long as the auditor indicates that there is both a quantitative and qualitative component of materiality then a general discussion with management and the audit committee does not do any harm. In some cases, management or the audit committee may want the auditor to look at some areas with a lower level of materiality.

c. Materiality guidelines usually involve applying percentages to some base, such as total assets, total revenue, or pretax income. The base should be a "stable" account

however, making total assets a better choice than pretax income.

In determining the amount to set for materiality, the auditor should consider the riskiness of the audit, as well as the stakeholders who will be making decisions based on the financial statement presentation.

2-27. *(Accounting and Audit Procedures)*

Sales

Existence or occurrence – the sales mentioned did occur

Completeness – the total sales amount represents all sales made in the year

Valuation and allocation – the total sales amount is correct and represents real prices for the transactions and the amounts are collectible.

Disclosure and presentation – sales are presented in the proper part of the income statement.

Rights and obligations – the sales transactions represents assets that belong to the company

Inventory

Existence or occurrence – the inventory exists

Completeness – the inventory amount represents all inventory on hand

Valuation and allocation – the inventory amount is valued correctly at the lower of cost or market.

Disclosure and presentation – inventory is presented in the proper part of the balance sheet.

Rights and obligations – the inventory amount represents an asset that is owned by the company

Accounts Receivable

Existence or occurrence – the receivables do exist, others owe the company money

Completeness – the amount of A/R represents all that the company is owed

Valuation and allocation – the A/R amount represents the amount the company expects to collect from the receivables.

Rights and obligations – the A/R amount represents an asset that is owed to the company, the company has a right to it

Disclosure and presentation – A/R is presented in the proper part of the balance sheet

2-28. *(Audit Framework – Audit Procedures)*

a. Construction equipment is an asset. That is the amount that the equipment was purchased for originally. The accumulated depreciation account is a summation of all the depreciation taken on the construction equipment. $1,278,000 - $386,000 = $892,000 is the current carrying value of the equipment. Around 25% has been depreciated to date. By the end of the useful life of the equipment, the carrying value will be zero (fully depreciated). The leased equipment represents assets that are rented and not owned.

b. The equipment held by the company could be characterized as fairly new. Only about 25% of the equipment value has been depreciated to date.

c. If the number of leased equipment pieces is small, examine each lease agreement using the four-step method (i.e. 90% fair value).

d. Randomly select invoices for new pieces of equipment and check that the total amount paid for the equipment is reflected in the total amount. Review the invoice to make sure the equipment was bought and not leased.

e. The auditor should question the method and calculations for the current year depreciation entries and make an assessment if the method, the number of years of useful life, and the calculations are reasonable.

f. First, the auditor can review past transactions and useful lives. If the company often recognized gains on trade-ins of assets, then the useful life was too short (the opposite if the company recognized losses). The auditor can also review management plans, industry usage, and industry practice for other insight on the useful life. Finally, the auditor can audit the internal controls on the system that calculates depreciation, and can utilize verbal inquiry for an explanation of useful life.

2-29. *(Group Research – Audit Committees)*

The goal of this exercise is to allow the student to see how audit committees actually function in the "real world." The differences between the various companies will prove that all audit committees, charters, and company goals are different. The latter part of the assignment will serve as a chance to hear student opinions on a yet unsettled issue.

2-30. *(Evaluating Corporate Governance)*

The purpose of this project is to get students out into the business community 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.

Cases:

2-31. *(Audit Committees)*

a. Important stakeholders that might serve on an audit committee could include:

- Representative of financial institutions with whom the organization does business.
- Other members of the family owning the company.
- Independent people in the community, e.g. civic leaders.
- Representatives of the workers.

Other potential audit committee members could include:

• Academics – skilled in auditing and/or financial reporting.

b. Some possibilities are: financial expertise, general business expertise, independence, diversity of experience in the business world, and a pre-existing knowledge of the company.

c. There are a number of audit charters that can be downloaded from almost any annual report. The students should identify some and the key characteristics of the audit committee charter.

d. We hope the students identify a number of key points beyond those outlined below. Some items for the students to consider as key elements of an effective information system include:

Information	**Frequency**	**Source of the Information**
Financial Statements	Quarterly and Monthly	CFO and accounting function.
Internal Audit Reports	Quarterly, and as warranted by the findings	Internal Audit Activity
External Audit Reports	Quarterly, and as warranted by the findings	External Audit
Key Performance Indicators	Sales Data – by product line or key factor. Quarterly. Production Data – by product line. Returns and analysis of any increase in returns. Quality of Credit	Accounting and Production System.
Regulatory Reports	As occurs	Regulatory Auditors
Risk Analysis	Summary of Key Risks and Approach to managing those risks – quarterly.	Risk Manager, CEO