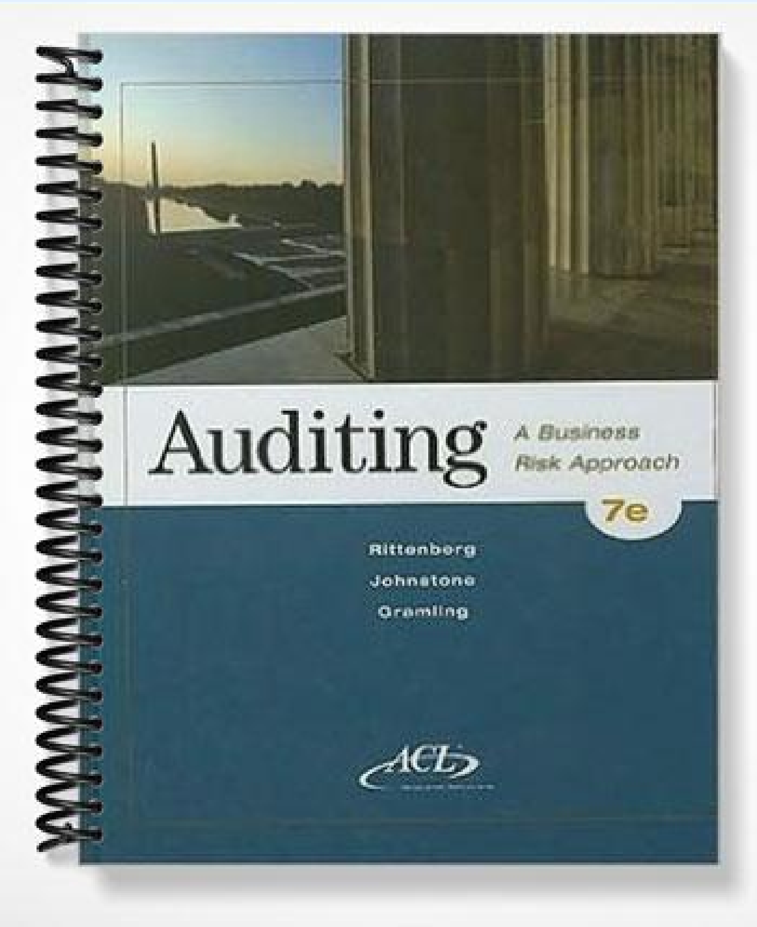
SOLUTIONS MANUAL



Auditing

A Business Risk Approach

7e

Rittenberg

Johnstone

Gramling

SOLUTIONS FOR CHAPTER 2

Corporate Governance

Review Questions:

2.1 Users should expect auditors to have the expertise, independence, and professional skepticism to render an unbiased and justified opinion on the financial statements. Auditors are expected to gather sufficient applicable evidence to render an independent opinion on the financial statements.

2.2 Corporate governance is defined as:

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

The key players in corporate governance are the stockholders (owners), board of directors, audit committees, management, regulatory bodies, and both internal and external auditors.

2-3. Cookie jar reserves are essentially liabilities or contra-assets that companies have overestimated in previous years to use when times are tougher to smooth earnings. The rationale is that the funds are then used to "smooth" earnings in the years when earnings need 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. The result is to increase earnings in the subsequent year.

2-4. The board of directors is often at the top of the list when it comes to responsibility for corporate governance failures. Some of the problems with the board of directors included:

- Inadequate oversight of management.
- Approval of management compensation plans, particularly stock options that provided perverse incentives, including incentives to manage earnings.
- Non-independent, often dominated by management.
- Did not spend sufficient time or have sufficient expertise to perform duties.
- Continually re-priced stock options when market price declined.

2.5 Some of the ways the auditing profession was responsible were:

- Too concerned about creating “revenue enhancement” opportunities for the firm, and less concerned about their core services or talents
- Were willing to “push” accounting standards to the limit to help clients achieve earnings goals
- Began to use more audit “shortcuts” such as inquiry and analytical procedures instead of direct testing of account balance.
- Relied on management representations instead of testing management representations.
- Were too often ‘advocates’ of management rather than protectors of users.

2-6. In the past decade, all parties failed to a certain extent. For detailed analysis, see exhibit 2.2 in the chapter and repeated here:

Corporate Governance Responsibilities and Failures

Party	**Overview of Responsibilities**	**Overview of Corporate Governance Failures**
Stockholders	**Broad Role:** Provide effective oversight through election of Board process, approve major initiatives, buy or sell stock.	Focused on short-term prices; failed to perform long-term growth analysis; abdicated all responsibilities to management as long as stock price increased.
Board of Directors	**Broad Role**: the major representative of stockholders to ensure that the organization is run according to the organization charter and there is proper accountability. **Specific activities** include: • Selecting management. • Reviewing management performance and determining compensation. • Declaring dividends • Approving major changes, e.g. mergers • Approving corporate strategy • Overseeing accountability activities.	• Inadequate oversight of management. • Approval of management compensation plans, particularly stock options that provided perverse incentives, including incentives to manage earnings. • Non-independent, often dominated by management. • Did not spend sufficient time or have sufficient expertise to perform duties. • Continually re-priced stock options when market price declined.
Management	**Broad Role:** Operations and Accountability. Managing the organization effectively and provide accurate and timely accountability to	• Earnings management to meet analyst expectations. • Fraudulent financial reporting.

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	shareholders and other stakeholders. **Specific activities** include: • Formulating strategy and risk appetite. • Implementing effective internal controls. • Developing financial reports. • Developing other reports to meet public, stakeholder, and regulatory requirements.	• Pushing accounting concepts to achieve reporting objective. • Viewed accounting as a tool, not a framework for accurate reporting.
Audit Committees of the Board of Directors	**Broad Role:** Provide oversight of the internal and external audit function and the process of preparing the annual accuracy financial statements and public reports on internal control. **Specific activities** include: • Selecting the external audit firm. • Approving any non-audit work performed by 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 auditor and external auditor and advising the Board (and management) on specific actions that should be taken.	• Similar to Board members – did not have expertise or time to provide effective oversight of audit functions. • Were not viewed by auditors as the 'audit client'. Rather the power to hire and fire the auditors often rested with management.
Self-Regulatory Organizations: AICPA, FASB	**Broad Role:** Setting accounting and auditing standards dictating underlying financial reporting and auditing concepts. Set the expectations of audit quality and accounting quality. **Specific roles** include: • Establishing accounting principles • Establishing auditing standards • Interpreting previously issued standards	• AICPA: Peer reviews did not take a public perspective; rather than looked at standards that were developed and reinforced internally. • AICPA: Leadership transposed the organization for a public organization to a "trade association" that looked for revenue enhancement opportunities for its members. • AICPA: Did not actively

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	• Implementing quality control processes to ensure audit quality. • Educating members on audit and accounting requirements.	involve third parties in standard setting. • FASB: Became more rule-oriented in response to (a) complex economic transactions; and (b) an auditing profession that was more oriented to pushing the rules rather than enforcing concepts. • FASB: Pressure from Congress to develop rules that enhanced economic growth, e.g. allowing organizations to not expense stock options.
Other Self-Regulatory Organizations, e.g. NYSE, NASD	**Broad Role:** Ensuring the efficiency of the financial markets including oversight of trading and oversight of companies that are allowed to trade on the exchange. **Specific activities** include: • Establishing listing requirements – including accounting requirements, governance requirements, etc. • Overseeing trading activities,	• Pushed for improvements for better corporate governance procedures by its members, but failed to implement those same procedures for its governing board, management, and trading specialists.
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External Auditors	**Broad Role:** Performing audits of company financial statements to ensure	• Pushed accounting concepts to the limit to help organizations

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	that the statements are free of material misstatements including misstatements that may be due to fraud. **Specific activities** include: • Audits of public company financial statements, • Audits of non-public company financial statements, • Other accounting related work such as tax or consulting.	achieve earnings objectives. • Promoted personnel based on ability to sell "non-audit products". • Replaced direct tests of accounting balances with a greater use of inquiries, risk analysis, and analytics. • Failed to uncover basic frauds in cases such as WorldCom and HealthSouth because fundamental audit procedures were not performed.
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2-7. Management has always been responsible for fairness, completeness, and accuracy of financial statements, but the Sarbanes-Oxley Act goes a step further by requiring the CEO and CFO to certify the accuracy of financial statements with criminal penalties as a punishment for materially misstated statements. The CEO and CFO must make public their certifications and assume responsibility for the fairness of the financial presentations. It thereby encourages organizations to improve their financial reporting functions.

2-8. Whistle blowing enables violations of a company's ethical code to be reported to appropriate levels in an organization, including the audit committee. Because of its presence, potential violators know that there is a real possibility and simple avenue by which inappropriate actions may be revealed. As such, it contains a preventive component that is indirectly helpful to the audit committee in fulfilling its corporate governance role.

2-9. The PCAOB is mandated by Congress to set standards for audits of public companies and perform quality control inspections of CPA firms that audit public companies. In order to carry out these responsibilities, the PCAOB requires all firms that audit U.S. listed (public) companies to register with it. It performs annual inspections on all audit firms that audit more than 100 public companies each year. It performs less frequent inspections, usually once every three years, for audit firms that audit less than 100 companies annually. The PCAOB issues Inspection Reports for each inspection that is performed. The first part describes problems they encountered in their reviews of audits and that part is made public. The second part describes problems that the firms have with their quality control process. The second part is not issued publicly unless the firms fail to address the problems pointed out within a reasonable time frame – usually no more than a year.

2-10. There are a number of provisions that are designed to increase auditor independence. First, Rule 201 of the Act prohibits any registered public accounting firm from providing many non-audit services to their *public* audit clients. Second, the audit committee became the "client" instead of management, and only the audit committee can hire and fire auditors. Third, audit partners are required to rotate every five years. Finally, the auditors are expected to follow fundamental principles of independence that have been enacted by the SEC (more details in Chapter 3).

2-11. The Sarbanes-Oxley Act was designed to "clean-up" corporate America, especially in the realms of financial reporting. The overall intent was to encourage better corporate governance; to make the audit committee the auditor's client; encourage the independence and oversight of the board, and improve the independence of the external audit profession. There were certainly many factors that led to the Sarbanes-Oxley Act, but the failures at Enron and WorldCom will probably be pointed to in the future as the major factors that led to the act being passed when it was. The Congress intended to develop a new reporting process that would provide just cause for the public to again trust financial statements and the audit processes leading up to the audit opinion.

2-12. 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.

2-13. 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.

2-14. 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.

2-15. 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.

2-16. The Sarbanes-Oxley Act applies only to public companies. Therefore, the Act does not require non-public companies to have audit committees. That is not to say that it does not happen or is not a good idea, however. Most stakeholders want an independent party to ensure that their interests are being considered. The AICPA recommends audit committees for smaller public companies.

2-17. 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.

2-18. The audit committee needs to ensure that the auditor is independent with respect to the annual audit. In order to ensure that independence, the audit committee must consider all other services that might be performed by the external auditor and approve any such services, in advance. If the audit committee approves the services, they are in essence saying that the provision of the services will not impair the auditor's independence.

2-19. The external auditor should discuss any controversial accounting choices with the audit committee and must communicate all significant adjustments made to the financial statements during the course of the audit. In addition, the processes used in making judgments and estimates as well as any disagreements with management should be communicated. Other items that need to be communicated include:

- All adjustments that were not made during the course of the audit,
- Difficulties in conducting the audit,
- The auditor's assessment of the accounting principles used and overall fairness of the financial presentation,
- The client's consultation with other auditors,
- Any consultation with management before accepting the audit engagement,

- Significant deficiencies in internal control.

2-20. 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,
- interactions with management regarding issues related to the audit, e.g.
    - providing requested information on a timely basis,
    - quality of financial personnel in making judgments,
    - accounting choices that tend to 'push the limits' towards aggressiveness or creating additional reported net income,
    - 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 concerning the internal auditor's findings and recommendations,
- 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.

2-21. Good corporate governance is correlated with increased corporate performance as measured by return on equity, or return on capital. Generally, good corporate governance reduces audit risk as it is less likely that the organization will suffer from problems of management integrity, or would have an environment that might allow or permit fraud. Less audit risk implies that the amount of work to render an opinion on the financial statements would also be less than that required for a company with poorer corporate governance.

2-22. 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 risk that the company will have materially misstated financial statements.

If a client does not have good governance, there are greater risks associated with the client. For example, their poor performance may lead to financial failure and lack of payment of the audit fee. Or their poor governance may lead to improprieties in financial reporting, which puts the auditor at risk in terms of litigation (if the improprieties go undetected by the auditor).

2-23. There are three important dimensions identified in Exhibit 2.5:

- Scope of Information on which assurance is provided,
- Nature of Organizations on which assurance is provided,
- Domicile of Company being audited.

These three dimensions influence the identification of applicable auditing standards as follows:

- A U.S. public company filing annual reports follows PCAOB standards.
- A U.S. non-public company issuing financial statements, follows AICPA standards,
- A foreign company filing financial statements in a different country follows International Standards or the standards of that country,
- U.S. companies reporting on other than financial information follows AICPA Attestation or Assurance Standards.

2-24.

- *Auditing Standards* apply to the auditor’s task of developing and then communicating an opinion on financial statements and, where applicable, independent opinions on the quality of an organization’s internal control over financial statements to the board, management, and outside third parties.
- *Assurance Standards* apply the auditor’s task of developing and communicating an opinion on financial information outside of the normal financial statements, or on non-financial information to management, the board, and outside third-parties. Assurance services are engagements in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users about the outcome of the evaluation or measurement of a subject matter against criteria.
- *Attestation Standards* is a term used by the AICPA to describe assurance services that involve gathering evidence regarding specific assertions and communicating an opinion on the fairness of the presentation to a third party.

Compilation and Review Standards refer to AICPA Standards that apply only to non-public companies where the board or a user has requested some assurance on the fairness of presentation of financial statements. These are referred to as negative assurance standards because the auditor does not gather enough evidence to support a statement as to whether the financial statements are fairly presented.

2-25. For the most part, the standards issued by the IAASB are quite similar to that of the two U.S. based audit standard setters. They differ in the following major ways:

- The auditor must assess the appropriateness of the accounting framework against which the audit opinion will be given (U.S. standards require only that the auditor communicate if the accounting is not consistent with U.S. GAAP.)
- IAASB utilizes a concept of Professional Skepticism rather than independence.

- The IAASB utilizes a concept of 'reasonable assurance' compared with the U.S. evidence on sufficiency of audit evidence and due professional care,
- The IAASB standards include both audit standards and assurance standards.

2-26. Assurance engagements are designed to provide 'positive assurance', i.e. the item being attested to is either properly presented, or is not properly presented. For example, one of the Big 4 firms provides assurance to the audience that the votes are properly maintained and counted for the Emmy Awards.

A 'limited assurance engagement' does not contemplate a full audit or assurance engagement such that sufficient information (evidence) is gathered to warrant a positive statement about whether the item being assured is, or is not, properly presented. Rather, based on a more limited amount of work, the auditor either states that 'nothing came to his or her attention – based on the limited procedures – that indicates something is not fairly presented'. This is often referred to as 'negative assurance'. An even more limited assurance engagement is one in which the accountant expresses 'no assurance' whatsoever on the item being reported.

2-27. The IAASB Audit Standards are quite consistent with that of the PCAOB as well as that of the AICPA. Most of the concepts are the same, but are stated differently. They are very similar in the following ways:

- Requirement of independence,
- Gathering and evaluation of sufficient evidence,
- Documentation of audit work,
- Audit designed to minimize audit risk,
- Due professional care vs. reasonable assurance,
- Nature of the audit report

The AICPA and the IAASB have announced a plan to work towards convergence of existing and future standards. The PCAOB has not yet announced a plan for convergence.

2-28. An audit engagement applies to the development of an opinion on an organization's financial statements. It is planned that the financial statements will be used by third parties who do not have direct access to client data. The audit engagement is a form of 'positive assurance' in which an opinion must be rendered.

An assurance engagement differs from an audit in a number of important dimensions:

- It can apply to almost any assertion that management wants to make as long as there is agreed-upon criteria by which to test management's assertion. It is preferable that the criteria are generally accepted.
- An assurance engagement generally requires a third party (although assurance can also be provided to the audit client), but it is an identified third-party as opposed to a potential user of financial statements,

- Assurance can be given on individual items of a company's financial statements, rather than the full set of statements.

2-29. Due professional care is the expectation that an audit will be conducted with the skill and care of a professional. The standard of due professional care plays a role in litigation against auditors. Plaintiffs will try to show that the auditor did not do what a reasonably prudent auditor would have done. To evaluate the standard, a third-party also decides whether someone with similar skills in a similar situation would have acted in the same way.

2-30. The three categories of audit standards are general standards, fieldwork standards, and reporting standards. General standards cover the characteristics of the auditor – technical training and proficiency, independence, and due professional care. Fieldwork standards provide guidance concerning planning and performing the audit. Reporting standards cover the essential elements of the auditor's communication, including the opinion, the criteria against which the assertions were tested, and an explanation of the basis for the attestor's opinion.

2.31 General Standards: The audit and attestation standards both require adequate technical training, expertise, and knowledge. They also both require independence and due professional care. The attestation standards differ in that they explicitly require links between assertions and reasonable criteria and a reasonably consistent estimation process; the audit standards implicitly assume this link.

Fieldwork Standards: The audit and attestation standards both require planning and sufficient evidence. The audit standards go a step further in requiring an understanding of the entity and its environment.

Reporting Standards: The reporting standards are completely different. Each reflects the underlying purpose of the engagement, i.e., the audit is designed to test whether the financials adhere to GAAP, whereas the attestation is designed to test a broader and more diverse set of assertions.

2-32. **PCAOB**

- sets audit standards for the audits of all public companies that are registered with the SEC

AICPA

- sets audit standards for audits of non-public companies
- sets attestation standards for areas other than public company reports on internal control

sets standards for assurance services that are less in scope than an audit, such as reviews and compilations

IAASB

– sets standards for financial statement audits on an international basis. Right now, the international standards are being increasingly accepted by all political jurisdictions, but particularly in Europe and many developing countries. Harmonization with U.S. will continue to be an objective.

GAO

- sets the standards for financial audits of governmental entities within the U.S. and certain other organizations that receive Federal financial assistance. Goes beyond financial statement audits and also provides standards related to program audits for economy and efficiency of operations.

IASB

– sets standards for the professional practice of internal auditing around the world. Incorporates other standards by reference where applicable.

2-33. Independence means objectivity and freedom from bias. The auditor can favor neither the client nor the third party in evaluating the fairness of the financial statements The auditor must be independent in fact and in appearance. Independence in fact means the auditor is unbiased and objective. An auditor could be independent in fact if he or she owned a few shares of common stock in an audit client, but might not appear independent to a third party. Independence in appearance means that a third party with knowledge of the auditor's relationship with the client would consider the auditor to be independent.

Professional skepticism, as used in the standards promulgated by the IAASB, has a broader meaning in that it refers to all of the factors that would affect an auditor's ability to exercise proper skepticism in an audit engagement. The factors to be considered vary from those associated with the individual, such as objectivity, to those associated with the structure of the firm. These are similar to the independence standards that emphasize both audit firm relationships to the client as well as objectivity. However, the IAASB emphasis on professional skepticism goes a bit further: an auditor could be objective, but not necessarily exercise professional skepticism, i.e. being open to potential explanations of events that are not consistent with the auditor's prior experiences. Professional skepticism appears to be a broader term than independence.

2.34 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 judgement 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 and consideration of qualitative factors such as the impact on important trends or ratios. The base should be a "stable" account however, making total assets a better choice than pretax income.

2-35. 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 that 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.

2-36. The auditor would take a sample of all additions 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.

2.37 The major planning steps are:

- Meeting with the audit client
- Developing an understanding of the client's business and 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.

Multiple Choice Questions:

2-38.	d.	
2-39.	d.	this is part of the profession’s problem, but not a cause of the failure.
2-40.	a.	
2-41.	d.	
2-42.	a.	
2-43.	d.	
2-44.	a.	
2-45.	d.	
2-46.	b.	
2-47.	f.	

Discussion and Research Questions:

2-48.

a. Corporate governance is defined as:

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

The key players in corporate governance are the stockholders (owners), board of directors, audit committees, management, regulatory bodies, and auditors (both internal and external).

b. In the past decade especially, all parties failed to a certain extent. For detailed analysis, see exhibit 2.2 in the chapter and reproduced below:

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	investigate causes, and suggest remedial actions.	
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c. There is an inverse relationship between corporate governance and risk to the auditor i.e. the better the quality of corporate governance, the lower the risk to the auditor. This relationship occurs because lower levels of corporate governance implies two things for the auditor:

- There is more likelihood that the organization will have misstatements in its financial statements because the commitment to a strong organizational structure and oversight is missing,
- There is greater risk to the auditor because the governance structure is not designed to prevent/detect such misstatements, and will likely not be as forthcoming when the auditor questions potential problems.

2-49.

Element of Poor Corporate Governance	Audit Activity to Determine if Governance is actually Poor	Risk Implication of Poor Governance
The company is in the financial services sector and has a large number of consumer loans, including mortgages, outstanding.	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 managed 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. The auditor will have to focus increased efforts on estimating loan losses, including a comparison of how the company is doing in relation to the other companies in the financial sector.
The CEO 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.	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 should carefully examine if the company's reported earnings and stock price differs broadly from companies in the same sector. If that is the case, there is a possibility of earnings manipulation and the auditor should investigate to see if such manipulation is occurring.
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	There 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	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

Element of Poor Corporate Governance	Audit Activity to Determine if Governance is actually Poor	Risk Implication of Poor Governance
community members – one is the President of the Chamber of Commerce and the other is a retired executive from a successful local manufacturing firm.	oversight function, including reports from both internal and external audit. 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. Finally, the problems with the other two members is that there is no indication that either of them have sufficient financial expertise.	of financial expertise means that the auditor does not have someone independent that they can discuss controversial accounting or audit issues that arise during the course of the audit. 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.
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 activity.	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. The external auditor will be more limited in determining the extent that his or her work can rely on the internal auditor.
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 is a risk that many aspects of governance, as well as internal control could be overridden. The auditor should look at policy manuals, as well as interview other members of management and the board – especially the audit committee.	The centralization of power in the CEO is a risk that many aspects of governance, as well as internal control could be overridden. This increases the amount of audit risk.
The Company has a loan committee. It meets quarterly to approve, on an ex-post basis all loans that are over $300 million	The auditor should observe the minutes of the loan committee to verify its meetings. The	There are a couple of elements in this statement that carries great risk to the audit and to

Element of Poor Corporate Governance	Audit Activity to Determine if Governance is actually Poor	Risk Implication of Poor Governance
(top 5% for this institution).	auditor should also interview the chairman of the loan committee to understand both its policies and its attitude towards controls and risk.	the organization. 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.
The previous auditor has resigned because of a dispute regarding the accounting treatment and fair value assessment of some of the loans.	The auditor should contact the previous auditor to obtain an understanding as to the factors that led the previous auditor to either resign or be fired. The auditor is also concerned with who led the charge to get rid of the auditor.	This is a very high risk indicator. The auditor would look extremely bad if the previous auditor resigned over a valuation issue and the new 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 they do not agree. This is a problem of auditor independence and coincides with the above identification of the weakness of the audit committee. This action confirms a generally poor quality of corporate governance.

2-50.

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. Assessing the competence of the audit committee can occur in a number of ways. Fortunately, the most persuasive evidence comes from the auditor's direct interaction with the audit committee on a regular basis. The auditor can determine the nature of questions asked, the depth of understanding shared among audit committee members, and the depth of items included in the audit committee agenda. Many audit committees have self-assessment of their activities using criteria developed by CPA firms, or by the National Association of Corporate Directors. The auditor should also review the minutes of the audit committee meetings and determine the amount of time spent on important issues.

An external auditor should be very reluctant to accept an audit engagement where the audit committee is perceived to be weak. There are a number of reasons including:

- The lack of good governance most likely influences the organization's culture and is correlated with a lack of commitment to good internal control.

- The auditor has less protection from the group that is designed to assist the auditor in achieving independence.
- The company may be less likely to be fully forthcoming in discussions with the auditor regarding activities that the auditor might question.

d. Internal auditing is an integral part of good corporate governance. It contributes to corporate governance in three distinct ways:

- It assists the audit committee in its oversight role by performing requested audits and reporting to the audit committee,
- It assists senior management in assessing the continuing quality of its oversight over internal control throughout the organization,
- It assists operational management by providing feedback on the quality of its operations and controls.

2-51.

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. 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.

Greed, the same reasons as the revenue recognition issue, was most likely the motivation for this creative accounting.

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.

Incentives were misaligned. Most of management compensation came in the form of stock options.

Better audit committees, increased auditor responsibility, identification of users as the client of the auditor, and management certification of statements will address the issue via requirements of the Sarbanes-Oxley Act.

2-52.

a. External auditors are supposed to perform audits of financial statements to ensure that the statements are free of material misstatements. They work for each of the parties to a certain extent and since they are independent, they will not favor any party over the other. The auditors are an independent and objective attestor that evaluates the quality of financial reporting and conveys an opinion to all parties involved in corporate governance.

b. Some of the ways the accounting profession was responsible were:

- Were too concerned about creating “revenue enhancement” opportunities, and less concerned about their core services or talents
- Were willing to “push” accounting standards to the limit to help clients achieve earnings goals

- Began to use more audit "shortcuts" such as inquiry and analytical procedures instead of direct testing of account balance.
- Relied on management representations instead of testing management representations.

c. The term "public watchdog" implies that auditors will look over the business world and stop bad things from happening. In terms of financial statements, Arthur Levitt said, "We rely on auditors to put something like the good housekeeping seal of approval on the information investors receive." The term "public watchdog" places a great deal of responsibility on the shoulders of auditors to protect the public's interests.

2-53.

a. Congress thought that the profession was no longer capable of setting its own standards to protect the public.

b. The PCAOB will set standards for audits of public companies and will define the profession's responsibilities for detecting fraud and other financial misdeeds. They will also establish and test quality control guidelines for public accounting firms that audit public companies. The inspection process keeps the public accounting 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.

c. 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 CPA's tend to think alike. The disadvantage to having only two CPA's on the board is that they do not form a majority. The Board sets standards for an industry made up almost entirely of CPA's, yet the strongest voice may not be that of a CPA.

d. This needs to be answered by looking at the PCAOB website at www.pcaobus.org and then looking for the current membership.

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

2-54.

a. The Sarbanes-Oxley Act changed responsibilities of management in the following ways:

- Requirement that CEO and CFO certify the financial statements and disclosures
- Requirement that companies provide a comprehensive report on internal controls over financial reporting

- Requirement to describe whether they have implemented a Corporate Code of Conduct, including provisions for whistleblowing, and processes to ensure that corporate actions are consistent with the Code of Conduct.

b. Under The Sarbanes-Oxley Act, management is no longer the "client." The auditor reports to the audit committee, who is independent of management. With these changes, the auditor should be able to be "tougher" on management because the audit committee will be demanding it. However, the auditor still has to work with management to gain access to needed information, as well as understanding management intent as management intent drives some accounting treatments.

c. The CEO and CFO, as members of management, are ultimately responsible for the financial statements. The chair of the audit committee and the external auditor are then responsible to a certain extent, probably more in the minds of the public than in reality. Finally, the Director of Internal Audit is the least responsible of the group, as they are essentially employees of management and the audit committee.

2-55

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.

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 for 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 not a conflict of interest as it is an audit or assurance service.

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 PCAOB is explicit that 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. The audit of effectiveness and efficiency is akin to consulting and would be interpreted by most people as compromising the auditor’s independence.

8. **Provide, at no cost, Seminars to Audit Committee Members.** *Approve.* The audit committee can make a decision as to whether a particular member will attend the seminar. It is one way that an audit committee member can keep up on the profession. The only potential problem would occur if the audit committee only relied on the audit firm for updates on accounting and audit issues.

9. Seminars for both Audit and Non-Audit Clients. *Recommend Approval.* The key is whether the audit committee feels that it may lose some of its objectivity in performing its oversight role.

2-56.

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, the audit committee sets the scope for and hires internal auditors. They must review the work of both parties.

b. The audit committee certainly takes on much more responsibility with the new standard. They will now be much more informed about the audit function and financial reporting processes within their company. 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 auditor has to be able to give a clean audit opinion. If they believe a certain accounting treatment to be wrong, they do not have to give that clean opinion. In this way, neither the audit committee nor management can necessarily solve a dispute.

d. The accounting choice is acceptable, and thus, the financial statements are fairly presented in accordance with GAAP. The fact that the auditor believes there is a better treatment should be communicated to important parties as follows:

- *Management* – the communication should be made directly, and the rationale for the auditor's opinion should be explained to management and documented in the working papers. The working papers should also include the client's rationale for the chosen accounting treatment.
- *Audit Committee* – Both management's chosen treatment and the auditor's preferred treatment should be communicated to the audit committee. Preferably the communication would include both verbal communication and written communication. The rationale for accepting management's accounting treatment should also be communicated.
- *Users of the Financial Statement* – There is no required communication to the outside users of the financial statements as long as the auditor has concluded that the financial statements are fairly presented in accordance with GAAP.

2-57

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 GAAS. 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.

c. Although they do not have stockholders, non-public entities would still want to have audit committees comprised of independent members. No matter what the organization, there are always stakeholders that want to make sure the company is being run properly. In the example of a school, taxpayers and parents want to know what is happening with public funds. Without an audit committee, the stakeholders would be trusting management to do everything properly, and in their best interests. There is a need for accountability and independent reporting for charities, governmental agencies, and other public-interest organizations. Audit committees help fill that role.

2-58.

a. Some ways that the impact of the Sarbanes-Oxley Act affects the external audit profession:

- The creation of the PCAOB puts a watchful eye on the accounting industry.
- Reporting on internal controls is required by the external auditor, adding to their workload but also strengthening their value to organizations and giving them more assurance when giving an audit opinion.
- Auditors can now feel more comfortable taking issues to the audit committee

- Audit partners must rotate off every five years. This will create a difficult transition at every client every five years.
- With the cooling off period, audit partners or managers cannot take jobs with clients as easily.

b. The Sarbanes-Oxley Act encourages effective internal audit functions for all public companies. The internal audit profession has been active in assisting companies in complying with the internal control provisions of the Act.

c. This could be argued either way. On one side, the legislation clearly creates a “watchdog” of the accounting industry, which decreases the power and prestige as the profession is no longer self-regulated. On the other hand, the Act and recent business press has brought a lot of attention to the accounting industry, which has educated the world about the role of accountants in the economy, and possibly increased their power and prestige.

Now, there is a general feeling that the public accounting profession has reestablished itself as a watchdog for investors and see the audit committee as their primary client. Overall, the consensus seems to be that the profession has regained a great deal of its prestige.

2-59

	IAASB	PCAOB	AICPA Auditing Standards Board.
Composition of Standards Setting Board.	18 members, with 10 nominated by IFAC members (2 of which are U.S.), 3 public members, and 5 from major firms, including all of the Big 4 plus Grant Thornton. Has less substantial legal authority.	5 members, of which only 2 can be CPAs, and the CPAs do not necessarily have to have audit experience. All are appointed by the SEC since the PCAOB is a quasi-regulatory organization. Has more substantial legal authority.	19 members, including one academic, a representative from each of the Big 4 firms, and a wide representation from other audit firms. All CPAs. Members are appointed by the AICPA. Has less substantial legal authority.

The GAO does not have outside members or a special board. Rather the GAO has a department within the GAO that deals with standard setting. However, they do subject all of their proposed standards to a period of public comment in which they seek feedback on the proposed standards.

b. The IAASB Standards differ from the PCAOB Standards in a number of ways. The following are some of the major ways in which they differ:

- Requirement to comment on the appropriateness of the accounting standard that serves as a criteria for fair presentation,

- A greater emphasis on professional skepticism as a fundamental concept of auditing,
- Includes assurance standards as well as audit standards,
- Has less specified standards on audits of internal control over financial reporting (standards only apply when user or regulator requires such a report).

c. The PCAOB standards differ from that of the ASB in two fundamental ways:

- They include a separate standard on the audit of internal control over financial reporting,
- They adhere to the SEC framework for determining auditor independence.

There are some areas that are starting to emerge that have differences such as new standards related to engagement quality review and documentation.

d. The IAASB standards are purposefully broader regarding the proposed accounting framework criterion because many companies (in spite of the movement to global convergence) still have unique aspects to their accounting rules or principles. In addition, there are other frameworks that exist besides accrual-based accounting, e.g. the cash basis or the tax based statements. Thus, the auditor is required to communicate as to whether the framework in which the management prepared the financial statements is appropriate. Then, the auditor opines on whether the financial statements are fairly presented in accordance with that framework.

In the U.S., the appropriate accounting standards have been recognized as Generally Accepted Accounting Principles, as promulgated by the FASB or its designees. The auditor does have a responsibility to communicate to management and the audit committee their view of the application of the accounting principles to the financial statements and whether the auditor believes that an alternative approach would more fairly present the financial statements – even if the chosen alternative falls within the range of acceptable GAAP.

2-60.

a. Good corporate governance is important to both auditors and investors because: (a) it is highly correlated with better organizational performance, and (b) it creates an atmosphere where it is less likely that there will be problems with the company's annual financial statements, or other financial reports.

b. Good corporate governance includes dual components of trust and accountability. Thus, a commitment to good corporate governance is also a commitment to excellence in accountability, including financial reports. In addition, well-run companies are generally well-run on multiple dimensions, e.g., corporate governance and operational performance.

c. There are a multitude of risks to the auditor if an organization is not committed to high quality corporate governance. Among the most important risks are:

- Potential lack of management integrity and trustworthiness regarding important accounting issues such as making estimates,
- Lack of commitment and support of the audit function, and especially important, a lack of support for audit independence and competence from the audit committee,
- Less emphasis on high quality internal controls resulting in more errors made in financial reports,
- Lack of transparency in all reporting to external bodies.

All of these combine into a situation that makes it much more likely that an auditor might be sued when materially misstated financial statements are issued.

d. The audit committee is a subcommittee of the board of directors and has oversight responsibilities relative to both the internal and external audit functions. The audit committee becomes the primary client of the auditor and is responsible for hiring or firing an external audit firm.

e. It is important to have directors that are fully independent of management in order to provide an objective evaluation of the work of management, and to ensure that the board pushes back against management when they propose actions that may be in management's best interests, but not in the best interests of the organization's shareholders or other stakeholders. This is all the more important in an environment in which management is compensated through stock options and in which there has been backdating of stock options.

f. It is hard to recommend accepting an engagement when the company has poor corporate governance - for all of the reasons identified above. Stated differently, performing an audit on a company that does not have good corporate governance increases the probability that there will be misstatements in the financial statements and the auditors may be sued. On the other hand, an auditor may accept an engagement for a company with less than good corporate governance when the auditor:

- believes the company is committed to improving corporate governance,
- believes the deficiencies in corporate governance, while important, are not so major that it will routinely lead to misstatements in the financial statements,

- structures the audit engagement with adequate work to obtain sufficient audit evidence to address the risks that are apparent, i.e., the auditor knows that he or she will have to perform more audit work on the client than would otherwise be necessary.

g. The standards are designed to protect the auditor from poor corporate governance in the following ways:

- Highlighting the need to control audit risk,
- Emphasizing that more audit evidence needs to be gathered when there is higher risk of material misstatement,
- Increasing the responsibility to the audit committee,
- Requiring the auditor to evaluate the competence and integrity of management.

2-61.

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."

Materiality is used in both accounting and auditing to help guide decisions about the magnitude of problems in the financial statements that must be fixed prior to issuance of an unqualified audit opinion; materiality is also used to guide decisions about areas that are considered key to the focus of the audit.

b. In the past when audit committees were not independent, materiality would not normally have 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 they know 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 as a starting point. 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, qualitative factors such as the effect on trends and ratios, as well as the stakeholders who will be making decisions based on the financial statement presentation.

2-62.

a. The standard of due professional care plays a role in litigation against auditors. Plaintiffs will try to show that the auditor did not do what a reasonably prudent auditor would have done. To evaluate the standard, a third-party also decides whether someone with similar skills in a similar situation would have acted in the same way.

b. Independence is vitally important to the auditing profession. Auditors exist to create confidence in the public that financial statements are free from material misstatement. When auditors are not independent, the public cannot necessarily trust that the statements are free from material misstatement, because they could have incentives to allow misstatements. Independence was a primary concern under The Sarbanes-Oxley Act because the auditing profession was rapidly losing the public trust that had taken decades to build. Congress saw the need to begin rebuilding this public trust through legislation, since self-regulation proved inadequate.

c. The question becomes one of how to remain skeptical despite continued indications that there are no major problems at the client. There are three fundamental approaches that are often taken:

- Continuous training and especially reinforcement of the importance of professional skepticism,
- Supervisory review throughout every aspect of an audit,
- A personal commitment from each auditor.

d. According to the Reporting Standards, the auditor does not have the option of simply walking away from the audit. The auditor is required to render an opinion if the auditor has developed sufficient evidence to render an opinion. Management could choose to issue financial statements without the auditor’s opinion, but then the auditor should notify the SEC (if applicable) and other parties that the auditor has reached an opinion, but management has chosen not to issue audited financial statements. If the auditor chooses to resign from the audit, then the auditor must disclose all the reasons for the resignation in a letter to the SEC.

2-63.

a. On the “pro” side, having the same standards makes audits more comparable for the public and the auditors. Nobody has to go through the trouble of reconciling differences in audits. On the “con” side, standards that seem appropriate for public clients may require more time and effort than necessary to gain comfort with a non-public company’s financial statements. Auditors should be able to work in the most efficient way if they are going to be profitable.

b. Examples could include the following: (1) public companies might have audit standards that are more applicable to larger and more complex entities, (2) non-public companies might have audit standards that adjust for weaker internal controls (e.g., lack of segregation of duties), (3) public companies might have audit standards that are geared toward more remote and less-informed users (e.g., shareholders) rather than less remote and better-informed users (e.g., bankers).

c. The main authority and standards come from the GAO and their standards for the audit of governmental entities. The auditor would look to the GASB for guidance on the proper accounting standards.

d. The audit committee determines the nature of the audit to be performed, given obvious restrictions based on the nature of the organization, i.e., publicly traded, private, governmental entity etc. For private entities, the audit committee could specify whether the audit is conducted according to PCAOB standards, international auditing standards, or AICPA standards (although using AICPA standards would currently be most likely). The audit committee has some leeway unless specified by regulation. For governmental entities and for US domiciled public companies filing reports in US securities markets, there is no choice: governmental entities must follow GAO standards; public companies must follow PCAOB standards.

2-64.

GAAS	Holmes' Failure to Comply with GAAS
General Standards: Technical Training and proficiency as an auditor	The college students did not have the proper training and proficiency and were not properly supervised.
Independence	Holmes lacked independence because of the financial interest in whether the bank loan is granted to Ray.

GAAS	Holmes' Failure to Comply with GAAS
Due professional care	Holmes failed to follow the fieldwork and reporting standards as a reasonably prudent auditor would have done. He did not critically review the work done or the judgments of the assistants.
Field work standards: Planning and supervision	Holmes accepted the engagement without first considering the availability of qualified staff. He also failed to supervise the assistants and plan the work adequately.
Understanding internal control structure	Holmes and the assistants did not obtain an understanding of the business, industry, or its internal control system.
Sufficient, competent evidence	Holmes gathered no evidence to corroborate the information in the financial statements. The work performed was more an accounting service than an audit service.
Reporting standards: Adherence to GAAP	The report made no reference to GAAP. Because Holmes did not do a proper audit, no opinion should have been expressed as to the fairness of the financial statements in accordance with GAAP.
Identification of circumstances in which such principles have not bee consistently observed	Holmes was not in a position to determine whether the accounting principles had been consistently observed due to the lack of evidence.
Informative disclosures	There were no footnotes. At a minimum, the significant accounting policies should be described. Disclosures were obviously inadequate, but the audit report did not mention this.
Opinion	Even though an opinion was expressed, it is not based on the results of a proper audit. A disclaimer should have been issued because Holmes failed to conduct an audit in accordance with GAAS.

2-65.

The goal of this assignment is to deliver the most up-to-date information on the status of the important GAO studies to the class.

2-66.

a. There is little doubt that the public accounting profession has the expertise to perform such a function. However, the services should not be allowed (for an audit client) because it would lead to a situation where auditors are auditing their own work, not that of others.

b. The public accounting profession would probably have a competitive advantage in performing such services because they spend so much time with the client that they have built a solid foundation of knowledge of them. Any investment banker would most likely be starting with a clean slate. Some could view this as an advantage for using the investment banking industry, however.

2-67.

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. The auditor should also determine whether there is an impairment in the value of the equipment.

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.

2-68.

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 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.

2-69.

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.

2-70.

a. Any individual on the board of directors can serve on the audit committee. It would be preferable to have individuals with some financial knowledge.
b. Financial and operational knowledge and a willingness to challenge management and interact with the external auditors.
c. The answer to this question will, of course, vary by company.

FORD MOTOR COMPANY AND TOYOTA MOTOR CORPORATION:

INTRODUCTION AND CORPORATE GOVERNANCE

Note to Instructor: Using these instructional resources based on Ford and Toyota, students will have the opportunity to apply the concepts from each chapter within the context of two actual companies. We have used these types of exercises in our undergraduate and graduate auditing classes at the University of Wisconsin-Madison. In the undergraduate classes, the instructors used these types of materials as the basis for in-class group activities. In the graduate classes, the instructors used these types of materials as the basis for both in-class group activities, and out-of-class small group cases and projects.

1a. Describe the history of Ford, it's current business, operating sectors, and reportable segments.

Ford was founded in 1919, and designs and sells automobiles. Ford operates an automotive sector and a financial services sector. The automotive sector has reportable segments consisting of North America (Ford, Lincoln and Mercury brand vehicles and parts), South America (primarily Ford brand vehicles and parts in this geographic region), Europe (primarily Ford brand vehicles and parts in Europe, Turkey, and Russia), Premier Automotive Group (Volvo, Jaguar, and Land Rover vehicles and parts), and Asia Pacific/Africa/Mazda (primarily Ford brand vehicles and parts in Asia Pacific and South Africa, along with Ford's approximately 33% ownership of Mazda-related investments). The financial services sector includes Ford Motor Credit Company (vehicle financing, leasing, and insurance), and other financial services (real-estate and vehicle-related financing/leasing of Volvo products).

1b. Describe the factors affecting Ford's profitability, and factors affecting the automotive industry in general.

Factors affecting Ford's profitability include: wholesale unit volumes, margins on vehicles sold (which is affected by the mix of vehicles sold, component costs, incentives and other marketing costs, warranty costs, and safety/emission/fuel economy technology costs), and a high level of fixed costs, including labor costs.

Factors affecting the auto industry in general include: (a) a competitive industry with many producers, none of whom are the dominant producer; (b) seasonality, whereby results of the third quarter are less favorable than those of other quarters because of high spring and summer demand; (c) raw materials costs and acquisition uncertainty; (d) low backlogs, (e) intellectual property that is difficult to develop, defend, and maintain, (f) and high potential warranty costs.

1c. Compare the nature of Ford's history, business sectors, and reportable segments to those of Toyota.

Like Ford, Toyota operates in the automotive and financial services sectors, and does business in the same general geographic areas except that Toyota has a very large presence in Japan. Toyota's discussion provides greater insight on the company's strategic direction compared to Ford. For example, Toyota notes strategic plans to offer a full lineup and distinguish products through hybrid technology (including luxury brands such as Lexus and through models specially directed at emerging markets), to localize globalize operations with targeted regional strategies, to promote key initiatives globally (e.g., maintaining leadership in research and development, improving efficiency, and expanding financing operations), to diversify in auto-related business sectors, to maintain financial strength, and to focus on shareholder value.

In addition to its traditional vehicle and financing operations, Toyota also reports an emerging presence in the pre-fabricated housing industry and in various emerging types of information technology.

2a. What is the purpose of the Form Def 14A?

The purpose of the Def14A is to provide a mechanism by which shareholders can gain the information they need to legally designate another person to vote their preferences in matters concerning stock.

2b. What does “Def” stand for?

The “Def” stands for “definitive proxy statement”, which is the terminology that the SEC uses to refer to the proxy statement.

2c. What types of information does a proxy contain?

The proxy contains information about proxy statements in general (for educational purposes of shareholders), the annual meeting of shareholders, the board of directors, corporate governance structures and policies, and management compensation.

3a. Who are the board members that are standing for election at Ford this year?

John Bond, Stephen Butler, Kimberly Casiano, Edsel Ford II, William Ford Jr., Irvine Hockaday, Richard Manoogian, Ellen Marram, Alan Mulally, Homer Neal, Jorma Ollila, Gerald Shaheen, and John Thornton.

3b. Which of them has been deemed “independent” of Ford?

Stephen Butler, Kimberly Casiano, Irvine Hockaday, Richard Manoogian, Ellen Marram, Homer Neal, Jorma Ollila, Gerald Shaheen, and John Thornton.

3c. How does Ford determine director independence?

Ford determines independence based on the NYSE’s Listed Company Rules, which state that:

- No director who is an employee or a former employee of the Company can be independent until three years after termination of such employment.
- No director who is, or in the past three years has been, affiliated with or employed by the Company’s present or former independent auditor can be independent until three years after the end of the affiliation, employment or auditing relationship.
- No director can be independent if he or she is, or in the past three years has been, part of an interlocking directorship in which an executive officer of the Company serves on the compensation committee of another company that employs the director.
- No director can be independent if he or she is receiving, or in the last three years has received, more than $100,000 during any 12-month period in direct compensation from the Company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).
- Directors with immediate family members in the foregoing categories are subject to the same three-year restriction.

- The following commercial, charitable and educational relationships will not be considered to be material relationships that would impair a director's independence:

  (i) if within the preceding three years a Ford director was an executive officer or employee of another company (or an immediate family member of the director was an executive officer of such company) that did business with Ford and either: (a) the annual sales to Ford were less than the greater of $1 million or two percent of the total annual revenues of such company, or (b) the annual purchases from Ford were less than the greater of $1 million or two percent of the total annual revenues of Ford, in each case for any of the three most recently completed fiscal years;

  (ii) if within the preceding three years a Ford director was an executive officer of another company which was indebted to Ford, or to which Ford was indebted, and either: (a) the total amount of such other company's indebtedness to Ford was less than two percent of the total consolidated assets of Ford, or (b) the total amount of Ford's indebtedness to such other company was less than two percent of the total consolidated assets of such other company, in each case for any of the three most recently completed fiscal years; and

  (iii) if within the preceding three years a Ford director served as an executive officer, director or trustee of a charitable or educational organization, and Ford's discretionary contributions to the organization were less than the greater of $1 million or two percent of that organization's total annual discretionary receipts for any of the three most recently completed fiscal years. (Any matching of charitable contributions will not be included in the amount of Ford's contributions for this purpose.)

3d. Why does independence matter to shareholders?

Independence matters to shareholders because board members have significant responsibilities in advising, challenging, and compensating management. If a board member is not independent from management, they may be unable to complete their responsibilities in a manner that is consistent with the best interests of the shareholders.

3e. What characteristics is Ford seeking when considering individuals to serve on its Board?

Ford notes that it seeks individuals:

- Who have high personal and professional ethical standards, integrity, and values;
- Who are committed to representing the long-term interests of all shareholders;
- Who have practical wisdom and mature judgment;
- Who are objective and inquisitive;
- Who help achieve diversity on the Board; and
- Who are willing to devote significant time to carrying out their Board responsibilities for a long period into the future?

3f How are board members compensated? Could the nature of the compensation potentially affect the director's independence? Explain

Ford directors are compensated differently depending on whether they are non-employee members. Employee members did not receive extra compensation for being directors. Ford has experienced financial difficulties and cut the director's compensation in half in 2007 to an amount of $100,000 per year, plus extra if they were chair of the audit committee or presiding director. In addition, they received stock awards of 3,496 shares, which was equal in value to approximately $39,000 in 2007. Finally, Ford furnished them with two vehicles for their use during the year and life and accidental death insurance of $200,000 and $500,000 respectively.

The issue of director compensation and independence is important because directors are the last line of management oversight and protection against management override. If the amount of stock were to become very high in relationship to the directors' net worth, then there might be a question as to whether director's would make accounting decisions based on the effect it might have on stock prices. In the case of Ford, approximately $40,000 of stock would not be significant enough to any of the independent directors that it would affect accounting decisions. Further, the value of the company's stock is more important over the longer run and would help the directors focus on building long-term value for the company. That objective should align them with the shareholders best interest.

4a. Describe Ford's audit committee and its duties.

Ford's audit committee has five members, all of whom are independent. The audit committee met 10 times in 2007. It selects the audit firm, reviews reports from the audit firm, reviews internal controls, discusses earnings releases, etc.

4b. Who is the designated financial expert on the audit committee? Does the designation as only one individual as a financial expert seem adequate for the complexity of Ford and the requirements of the Sarbanes-Oxley Act?

The designated financial expert is Stephen Butler. He was a partner for 33 years at KPMG, and served as KPMG's CEO from 1996 to 2002. Thus, his qualifications seem more than adequate. It is interesting that Ford designates only one person as a financial expert on the audit committee. Many organizations will designate all of their members as financial experts. Thus, it is possible that organizations may be using different criteria in designating someone as an expert even though they are adhering to the same standard.

5a. Review the audit committee's report and describe its primary contents.

The report contains information about audit fees and auditor independence.

5b. Audit fees were not always publicly disclosed. In fact, such disclosure only became mandatory since 2000 in the United States. Why is public disclosure of audit and other fees paid to the audit firm important?

Public disclosure of audit and other fees paid to the audit firm is important in helping shareholders assess auditor independence. With these disclosures, shareholders can better understand the relative size of the Ford audit engagement to the other engagements of PricewaterhouseCoopers LLP, and they can be assured that non-audit fees do not dwarf audit fees to such a great extent that the auditor is no longer independent economically or in mental attitude. What fees, besides the audit, were billed to the Company by the PricewaterhouseCoopers?

See the Audit Committee Report in the Proxy statement for a full description of fees (p. 13). In addition to audit fees, Ford made the following types of payments to PwC in 2007 and 2006:

	2007	2006
Audit Related fees (internal control, etc.)	$13.3 mil	$4.2 mil
Tax Related Fees	$ 5.5 mil	$6.6 mil
All Other	$ 0.0	$0.0 mil

5c. What was the nature of audit-related fees for 2007 and 2006? Why is it important that these fees be disclosed?

Audit Fees were $39.0 for 2007 and $41.6 in 2006. Thus, the audit fees went down in 2007, but audit-related fees (see above) went up in 2007, so the total fees paid to PwC increased in 2007. The fees should be disclosed to ensure complete transparency and thus independence of the audit function. Users should know whether or not the actions of the independent public accounting firm might be influenced by the fees from a client. It is important (and required by the PCAOB) that other fees paid to the audit firm be fully disclosed and that the audit committee renders a decision as to whether the nature of the fees paid to the audit firm would affect the external auditor’s independence.

5d. What are the audit fees as a percentage of (a) total revenue, and (b) total assets?

This is a statistic that is not often examined. For the year 2007, PwC had audit fees of $39.0 Million. Ford’s total revenue was $172.5 Billion and total assets were $285.727 Billion. Thus, the audit fees paid to PwC represents 0.023% of revenue and 0.014% of total assets. The amount is interesting is that the audit represents only about 1/100 of a percent of the total assets. There are some scales of economy to a large audit that we will examine further in the text as we look at the audit fees as a percentage of revenue of smaller companies.

5e. PricewaterhouseCoopers performs significant tax work for Ford. What is the nature of the work performed? Under what circumstances might performance of tax work for the audit client potentially jeopardize the independence of the firm?

The types of tax services provided included assistance with tax compliance and the preparation of tax returns, tax consultation, planning and implementation services, assistance in connection with tax audits, tax advice related to mergers, acquisitions and divestitures, and tax return preparation services provided to international service employees (“ISEs”) to minimize the cost to the Company of these assignments.

Tax work that is very significant in dollar amount might jeopardize the independence of the audit firm if it becomes more important to the audit firm than the financial statement audit, thereby having the potential to impair independence in fact or in appearance.

5f. What were the total audit fees for Toyota? What percentage were the fees of total revenue and total assets?

Total Revenue for Toyota in 2007 was 23,948,091 yen, or about $230.447 billion U.S. Dollars.
Total Assets for Toyota in 2007 was 28,731,595 yen, or about $**276.637 billion in U.S. Dollars.**

Toyota also used PricewaterhouseCoopers as their external auditor.

The fees paid in 2007 and 2006 were as follows: (in millions)

	2007	**2006**
Audit Fees (1)	2,025 Y	3,779 Y
	$19.49	$36.38
Audit-related Fees (2)	604 Y	180 Y
	$5.81	$1.72
Tax Fees	896 Y	679 Y
	$5.59	$6.53

Toyota's audit fees thus represent 0.0084% of revenue and 0.0070% of assets.

Note, not only was Toyota a less risky company, but associated with the lower risk is significantly lower audit costs based on either revenue or assets. To further explore this question, the students could look at geographic dispersion, or cost of auditing in Japan vs. the U.S. However a quick review indicates that Toyota is as geographically disbursed as is Ford. However, Toyota has usually had fewer types of automobiles and used similar platforms across lines of cars. This can lead to less complexity for operations, but also for financial issues. In addition, Ford does have significant post-retirement benefits or OPEB's that have to be separately audited by PwC.

6a. No answer needed.

6b. That the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that—

(1) the signing officer has reviewed the report;

(2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers—
(A) are responsible for establishing and maintaining internal controls;
(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—
(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

6c. Why do you think that Congress felt that it was necessary to require executive officers to make affirmative claims such as Alan Mulally's, "the information contained in the Report fairly presents...the financial condition and results of operations of the Company"?

Congress felt it was necessary to require executive officers to make these certifications because of investor concerns following the financial market crisis and various frauds that occurred in the early 2000's. This requirement is a way to assure investors that management is affirmatively making assertions *in writing* that were only implied and "taken for granted" assertions prior to SOX.

6d. How do you think that signing these certifications affects the judgment processes of these executive officers, if at all?

The prevailing belief on this topic is that the act of signing such a certification heightens the importance of the contents of the document to the individual signing it. They are more likely to take the matter very seriously. Further, it helps to demonstrate accountability to investors.

6e. Would you feel comfortable making these certifications if you were in executive management at Ford? What steps would you have to take in order to reach that level of comfort? Remember, management cannot rely on the work of the external auditor in developing a basis for their certification.,

The point of requiring these certifications is to make executive officers a bit uncomfortable, so most students will likely respond affirmatively to this question because it highlights the legal liability that the individual is assuming.

Management needs to develop procedures that they can rely on in order to gain assurance that internal control continues to be operating effectively. Companies have taken a variety of approaches to gain that assurance including:

- Sub-certifications by managers at all levels in the organization,
- Review of the internal control process by the internal audit department,
- Results of 'self-assessment' tests by departments, or groups, or divisions.
- Monitoring of internal controls following the guidelines issued by COSO.

6f. Explain how management would (a) utilize the internal audit function, and (b) develop requirements of mid-level managers in the process of developing support for their certifications

In practice, executive officers sign these documents only after they receive confirmation that other lower level individuals have also signed certifications regarding their own smaller spheres of influence. Executive officers keep copies of the other individuals' signatures as evidence of due diligence in obtaining their own assurances regarding the certifications that pervade the organization from the highest to the lowest levels.

Internal auditors have taken leading roles in helping organizations meet their internal control and disclosure controls certifications. The work performed by internal auditing has varied by organization and includes the following types of roles:

- Leading the certification process by developing testing mechanisms, following up on individual tests, and assisting the company in remediating control problems.
- Training various departments on the principles of internal control and then testing internal controls,
- Working with the external auditors to provide test results on internal controls.
- Assisting management in evaluation of subjective areas, such as the control environment and areas such as ethics.

7. Read Toyota's corporate governance disclosures. What are the significant differences in corporate governance between Toyota and Ford?

The primary differences are that:

- None of Toyota's directors is independent.
- There are no committees such as an audit committee or compensation committee of the Board. Rather, Toyota uses seven "corporate auditors" that serve those functions. However, only four of those individuals are "outsiders" from management, and rules determining "outsiders" are not the same as those determining "independent" directors for Ford under the NYSE rules.
- Audit committee members do not necessarily have to have expertise in accounting, nor are they required to possess other special knowledge. There is no designated "financial expert".
- Other differences exist in terms of the corporate governance structure, internal control requirements, and requirements regarding executive compensation, but these differ more in form than underlying substance from Ford's policies.

8. The disclosures on these pages provide details of proposals that individual shareholders intend to make at the annual shareholders meeting. Read Proposals 6 and 7 by John Chevedden. What are his proposals, and what concerns is he expressing about the corporate governance structure at Ford? What is the rationale for the Board's recommendation regarding Mr. Chevedden's proposals? Evaluate the positives of the proposal and the Board recommendation to develop your conclusion on the two proposals.

In Proposal 6, Mr. Chevedden is expressing concerns about the quality of the overall board of directors, and seeks to abolish Ford's current restriction that shareholders may not call special meetings between annual meetings. He is also expressing concerns about the independence and long tenure of various board members. In Proposal 7, Mr. Chevedden is expressing concerns about the voting rights that Ford family shareholders enjoy (16 votes per share, compared to the one vote per share allowed for regular shareholders), and his proposal calls for these voting right differences to be abolished. Most students will not be surprised that the Board recommends rejection of these proposals. Students will likely point out, however, that the ability of an individual shareholder to express these types of views is consistent with an open and responsive system of corporate governance in the United States in general and at Ford in particular.

The Board's recommendations most likely hinge on two factors:

- The long-held voting position of Ford that developed from a family company that went public, and the reluctance of the Ford family to give up the power that they have accreted over the years,
- The Board, as well as the Ford family, also suffers when the company's stock does not do well. Thus, they are as committed as anyone to achieve better operating and financial performance.
- The Board often needs to react to events on a timely basis; thus restricting shareholder meetings to once a year would not allow the board to act appropriately in the market place, particularly with references to mergers, acquisitions, or important divestitures – which would be aimed at making Ford a more profitable company.
- The Ford family has purchased and held shares under the existing structure for almost a decade. They do so because the structure has had long-term benefits to both the family and to the company. To change that basic structure now would be unfair to the family and would violate an important trust for the organizations.
- Finally, Ford has moved in the past two years to strengthen outside influence on the company by adding a President from outside the Ford family.

9. Review the code of ethics for senior management and the board of directors. What are the main components of these codes? Provide a critique of the components and overall message contained in the codes.

The Code of Ethics for Senior Management and the Board follows. Instructors should review these documents with students to assure that students are familiar with the contents of such codes. Student critiques of the codes will of course vary by class and instructor, so no solution to that activity is provided here.

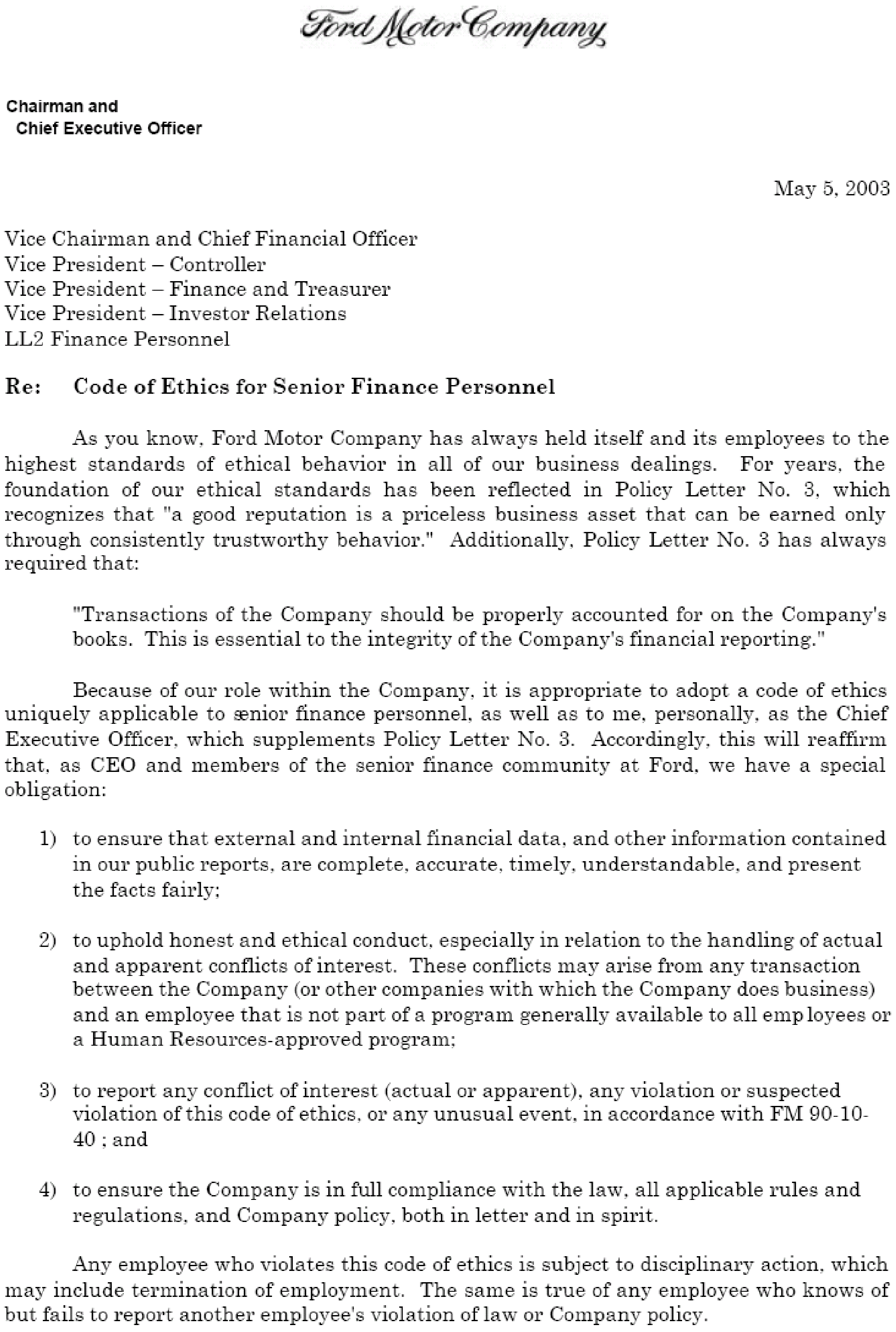
10. What guidelines does management provide as to how deviations for the Company's Code of Ethics will be handled?

The Board of directors provides that appropriate actions will be taken if there is a violation of the code, but they do not describe the nature of the appropriate actions. The specifics are:

"Any suspected violations of this Code should be reported promptly to the Chairman of the Board of Directors, the Chair of the Nominating and Governance Committee or the Presiding Director. Violations will be investigated by the Board or by a person or persons designated by the Board and appropriate action will be taken in the event of any violations of the Code. Any waiver of this Code occurring subsequent to its effective date may be made only by the Board of Directors or the Nominating and Governance Committee and any such waiver will be promptly posted to the Company's public website.

The senior finance code is interesting in that it specifically cites the possibility of termination, as well as similar actions to be taken by people who know of a violation, but do not report the violation:

“Any employee who violates this code of ethics is subject to disciplinary action, which may include termination of employment. The same is true of any employee who knows of but fails to report another employee's violation of law or Company policy.



Ford Motor Company

**Chairman and
Chief Executive Officer**

May 5, 2003

Vice Chairman and Chief Financial Officer
Vice President – Controller
Vice President – Finance and Treasurer
Vice President – Investor Relations
LL2 Finance Personnel

Re: Code of Ethics for Senior Finance Personnel

As you know, Ford Motor Company has always held itself and its employees to the highest standards of ethical behavior in all of our business dealings. For years, the foundation of our ethical standards has been reflected in Policy Letter No. 3, which recognizes that "a good reputation is a priceless business asset that can be earned only through consistently trustworthy behavior." Additionally, Policy Letter No. 3 has always required that:

> "Transactions of the Company should be properly accounted for on the Company's books. This is essential to the integrity of the Company's financial reporting."

Because of our role within the Company, it is appropriate to adopt a code of ethics uniquely applicable to senior finance personnel, as well as to me, personally, as the Chief Executive Officer, which supplements Policy Letter No. 3. Accordingly, this will reaffirm that, as CEO and members of the senior finance community at Ford, we have a special obligation:

1) to ensure that external and internal financial data, and other information contained in our public reports, are complete, accurate, timely, understandable, and present the facts fairly;

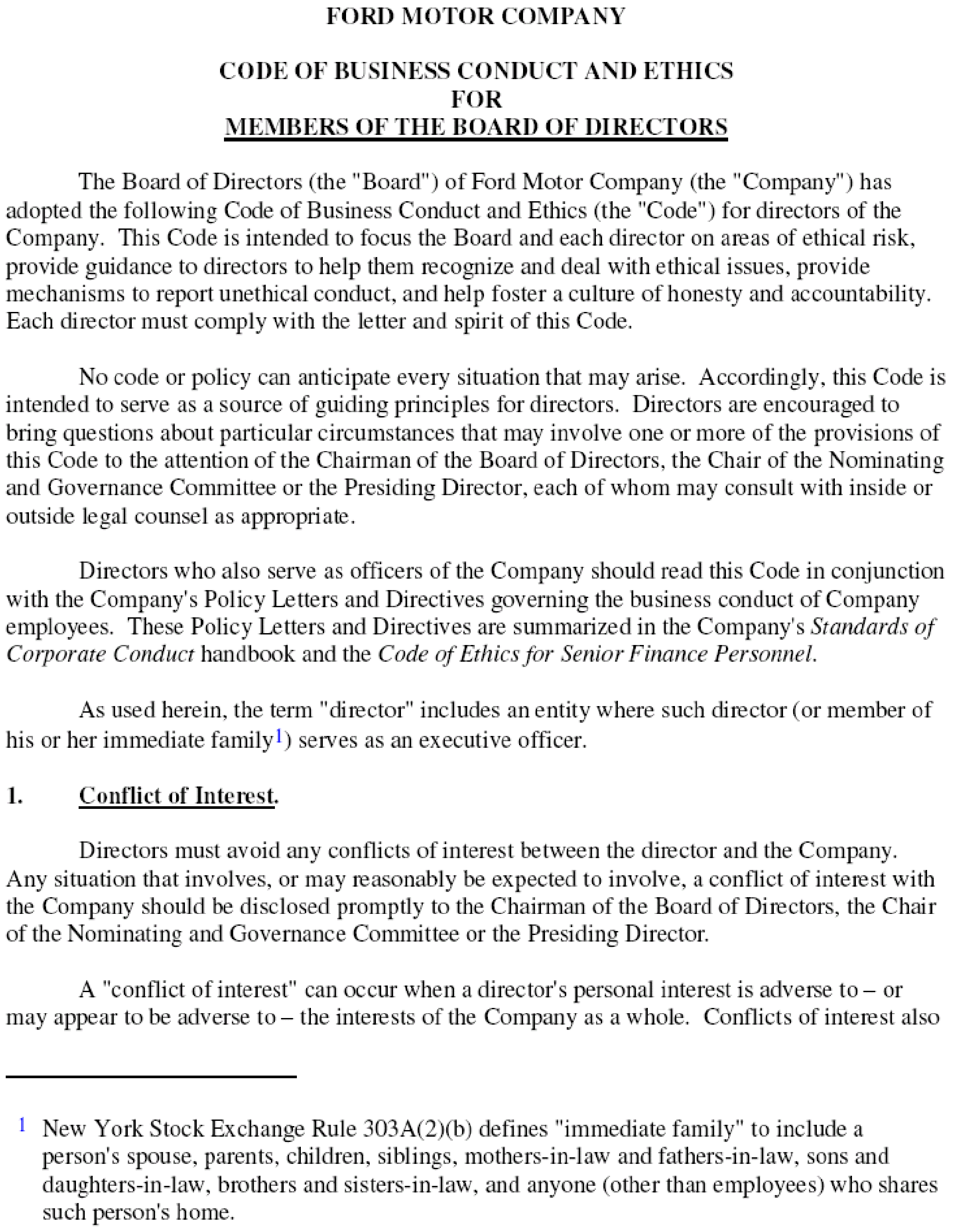
2) to uphold honest and ethical conduct, especially in relation to the handling of actual and apparent conflicts of interest. These conflicts may arise from any transaction between the Company (or other companies with which the Company does business) and an employee that is not part of a program generally available to all emp loyees or a Human Resources-approved program;

3) to report any conflict of interest (actual or apparent), any violation or suspected violation of this code of ethics, or any unusual event, in accordance with FM 90-10-40 ; and

4) to ensure the Company is in full compliance with the law, all applicable rules and regulations, and Company policy, both in letter and in spirit.

Any employee who violates this code of ethics is subject to disciplinary action, which may include termination of employment. The same is true of any employee who knows of but fails to report another employee's violation of law or Company policy.

The Code of Ethics for Board members is as follows:



FORD MOTOR COMPANY

CODE OF BUSINESS CONDUCT AND ETHICS FOR MEMBERS OF THE BOARD OF DIRECTORS

The Board of Directors (the "Board") of Ford Motor Company (the "Company") has adopted the following Code of Business Conduct and Ethics (the "Code") for directors of the Company. This Code is intended to focus the Board and each director on areas of ethical risk, provide guidance to directors to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help foster a culture of honesty and accountability. Each director must comply with the letter and spirit of this Code.

No code or policy can anticipate every situation that may arise. Accordingly, this Code is intended to serve as a source of guiding principles for directors. Directors are encouraged to bring questions about particular circumstances that may involve one or more of the provisions of this Code to the attention of the Chairman of the Board of Directors, the Chair of the Nominating and Governance Committee or the Presiding Director, each of whom may consult with inside or outside legal counsel as appropriate.

Directors who also serve as officers of the Company should read this Code in conjunction with the Company's Policy Letters and Directives governing the business conduct of Company employees. These Policy Letters and Directives are summarized in the Company's *Standards of Corporate Conduct* handbook and the *Code of Ethics for Senior Finance Personnel*.

As used herein, the term "director" includes an entity where such director (or member of his or her immediate family[1]) serves as an executive officer.

1. Conflict of Interest.

Directors must avoid any conflicts of interest between the director and the Company. Any situation that involves, or may reasonably be expected to involve, a conflict of interest with the Company should be disclosed promptly to the Chairman of the Board of Directors, the Chair of the Nominating and Governance Committee or the Presiding Director.

A "conflict of interest" can occur when a director's personal interest is adverse to – or may appear to be adverse to – the interests of the Company as a whole. Conflicts of interest also

[1] New York Stock Exchange Rule 303A(2)(b) defines "immediate family" to include a person's spouse, parents, children, siblings, mothers-in-law and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than employees) who shares such person's home.

arise when a director, or a member of his or her immediate family, receives improper personal benefits as a result of his or her position as a director of the Company.

This Code does not attempt to describe all possible conflicts of interest that could develop. Some of the more common conflicts from which directors must refrain, however, are set out below.

- *Relationship of Company with third-parties*. Directors may not engage in any conduct or activities that are inconsistent with the Company's best interests or that disrupt or impair the Company's relationship with any person or entity with which the Company has or proposes to enter into a business or contractual relationship.

- *Compensation from non-Company sources*. Directors may not accept compensation (in any form) for services performed for the Company from any source other than the Company.

- *Gifts*. Directors and members of their families may not accept gifts from persons or entities who deal with the Company in those cases where any such gift has more than a nominal value or where acceptance of the gifts could create the appearance of a conflict of interest.

- *Personal use of Company assets*. Directors may not use Company assets, labor or information for personal use unless approved by the Chairman of the Board of Directors, the Chair of the Nominating and Governance Committee or as part of an approved compensation or expense reimbursement program.

2. Corporate Opportunities.

Directors are prohibited from: (a) taking for themselves personally opportunities related to the Company's business; (b) using the Company's property, information, or position for personal gain; or (c) competing with the Company for business opportunities, *provided*, *however*, if the Company's disinterested directors determine that the Company will not pursue an opportunity that relates to the Company's business, a director may do so.

3. Confidentiality.

Directors should maintain the confidentiality of information entrusted to them by the Company and any other confidential information about the Company that comes to them, from whatever source, in their capacity as a director, except when disclosure is authorized or legally mandated. For purposes of this Code, "confidential information" includes all non-public information relating to the Company.

4. Compliance with laws, rules and regulations; fair dealing.

Directors shall comply, and satisfy themselves that appropriate policies and procedures are in place for compliance by employees, officers and other directors, with laws, rules and regulations applicable to the Company, including insider trading laws. Transactions in Company securities are governed by the Company's policies with respect to trading such securities and transactions in Company securities should be reviewed in advance with the Secretary's Office.

Directors shall satisfy themselves that appropriate policies and procedures are in place for fair dealing by employees and officers with the Company's customers, suppliers, competitors and employees.

5. Encouraging the reporting of any illegal or unethical behavior.

Directors should promote ethical behavior and take steps to ensure the Company: (a) encourages employees to talk to supervisors, managers and other appropriate personnel when in doubt about the best course of action in a particular situation; (b) encourages employees to report violations of laws, rules, regulations, the Company's *Standards of Corporate Conduct,* or the *Code of Ethics for Senior Finance Personnel* to appropriate personnel; and (c) informs employees that the Company will not allow retaliation for reports made in good faith.

6. Compliance Procedures.

Any suspected violations of this Code should be reported promptly to the Chairman of the Board of Directors, the Chair of the Nominating and Governance Committee or the Presiding Director. Violations will be investigated by the Board or by a person or persons designated by the Board and appropriate action will be taken in the event of any violations of the Code. Any waiver of this Code occurring subsequent to its effective date may be made only by the Board of Directors or the Nominating and Governance Committee and any such waiver will be promptly posted to the Company's public website.

Any amendments to this Code will be promptly posted to the Company's public website.

March 2004