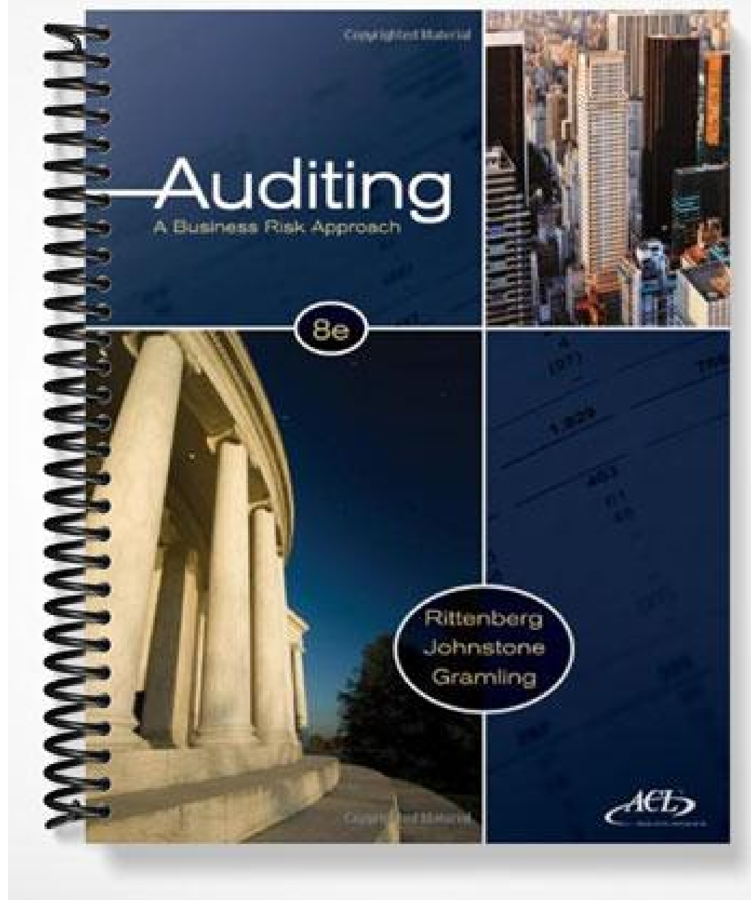
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Solutions for Chapter 2

Corporate Governance and Audit

Review Questions:

2-1. 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.

2-2. 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	• 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

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Party	Overview of Responsibilities	Overview of Corporate Governance Failures
	• Overseeing accountability activities.	declined.
Management	**Broad Role:** Operations and Accountability. Managing the organization effectively and provide accurate and timely accountability to 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.	• Earnings management to meet analyst expectations. • Fraudulent financial reporting. • 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	• AICPA: Peer reviews did not take a public perspective; rather than looked at standards that were developed and reinforced

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
	quality and accounting quality. **Specific roles** include: • Establishing accounting principles • Establishing auditing standards • Interpreting previously issued standards • Implementing quality control processes to ensure audit quality. • Educating members on audit and accounting requirements.	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 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.
Regulatory Agencies: the SEC	**Broad Role:** Ensure the accuracy, timeliness, and fairness of public reporting of financial and other information for public companies. **Specific activities** include: • Reviewing all mandatory filings with the SEC, • Interacting with the FASB in setting accounting standards, • Specifying independence	• Identified problems but was never granted sufficient resources by Congress or the Administration to deal with the issues.

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
	standards required of auditors that report on public financial statements, • Identify corporate frauds, investigate causes, and suggest remedial actions.	
External Auditors	**Broad Role:** Performing audits of company financial statements to ensure 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.	• Pushed accounting concepts to the limit to help organizations 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.
Internal Auditors	**Broad Role:** Perform audits of companies for compliance with company policies and laws, audits to evaluate the efficiency of operations, and audits to determine the accuracy of financial reporting processes. **Specific activities** include: • Reporting results and analyses to management, (including operational management), and audit committees, • Evaluating internal controls.	• Focused efforts on 'operational audits' and assumed that financial auditing was addressed sufficiently by the external audit function. • Reported primarily to management with little effective reporting to the audit committee. • In some instances (HealthSouth, WorldCom) did not have access to the corporate financial accounts.

2-3. 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.

2-4. 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.

2-5. 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 bad year.

2-6. 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.

2-7. 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 activities 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.

2-8. 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. The PCAOB also has the responsibility to register firms that audit public companies and conduct investigations and enforcement activities related to violations of standards and other regulations.

2-9. 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.

2-10. 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, which includes oversight of the whistleblowing program.

2-11. 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).

2-12. Management is responsible for issued financial statements. From a financial reporting perspective, it is management's responsibility to:

- Choose which accounting principles best portray the economic substance of company transactions.
- Implement a system of internal control that assures completeness and accuracy in financial reporting.
- Ensure that the financial statements contain accurate and complete disclosure.

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. 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.

2-14. 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.

2-15. 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 auditors carry out their responsibilities in an independent and competent manner.

2-16. 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.

2-17. 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. Various organizations recommend audit committees for nonpublic companies.

2-18. 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.

Exhibit 2.5, which is reproduced below, provides a more complete listing:

Exhibit 2.5 Communication to Audit Committees
Examples of Required Communications to Audit Committees

Auditor's Responsibility under Generally Accepted Auditing Standards
The auditor must clearly communicate the audit firm's responsibility to perform the audit according to relevant auditing standards, and independently assess the fairness of the financial statements; to assess the quality of the entity's internal controls over financial reporting; to attest to the fairness of management's report on internal accounting over financial reporting; and to design the audit to detect material misstatements.

Significant Accounting Policies
The auditor should ensure that the audit committee is informed about the initial selection of, and changes in, significant accounting policies or their application, and discuss the quality of accounting principles used.

Management Judgments and Accounting Estimates
Many corporate failures have involved manipulation of accounting estimates such as loan loss reserves. The auditor should ensure that the audit committee is aware of the processes used by management in making sensitive accounting estimates, and the auditor's assessment of those processes and accompanying estimates.

Significant Audit Adjustments
Significant audit adjustments may reflect on the stewardship and accountability of management. The audit committee should be made aware of such adjustments, even if management readily agrees to make them. Significant adjustments, by definition, suggest that there have been internal control failures that must be communicated to management and the audit committee.

Judgments about the Quality of the Company's Accounting Principles
The auditor needs to discuss with the audit committee the quality of the company's financial statements and not sure whether they are acceptable under GAAP. Auditors should be prepared to have a frank discussion about differences in assessments of the quality of the financial statements.

Other Information in Annual Reports
The auditor should briefly describe his or her responsibility to review other information contained in an annual report and whether such information is consistent with the audited financial statements.

Disagreements with Management
All major accounting disagreements with management, even if eventually resolved, should be discussed with the audit committee. This requirement is intended to insulate the auditors from management pressure to change or bend accounting treatments to suit management and should remove any subtle hints that the auditing firm may be replaced because it disagrees with management's proposed accounting treatments.

Consultation with Other Accountants
In some instances the auditor may become aware that management has consulted with other accounting firms about an accounting policy or its application. In those instances, the auditor should inform the audit committee of this consultation and possibly provide an assessment of the consultation.

Major Issues Discussed with Management Before Retention
During the proposal and hiring stages of the engagement, management and the auditor likely discussed issues related to accounting principles and audit standards. These issues should be discussed with the audit committee.

Overview and Planned Scope of the Audit
The auditor needs to communicate the planned scope of the audit engagement to the audit committee and have a discussion with it on the adequacy of the planned scope, as well as the materiality chosen for the audit.

Difficulties in Performing the Audit
Auditors may experience various difficulties in performing the audit such as scheduling, cooperation, etc. The auditor should discuss these issues with the audit committee.

Representations Requested from Management
The auditor normally requests representations from management on a number of important issues, such as management's responsibility for the financial statements, the appropriate allowances for accounts that need to be adjusted to market value, and the quality of controls. The nature of these requests, as well as management's responses, should be shared with the audit committee.

2-19. 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.

2-20. 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).

2-21. In assessing the quality of governance, the auditor will:

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

2-22. 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.

2-23. Audit committee members are required to be independent. At least one audit committee member should be a financial expert while the other members should have sufficient accounting and auditing knowledge. Further, the audit committee members should have an interest and willingness to ask questions of (and possibly challenge) management and the external auditors.

2-24. Corporate governance is an oversight structure that ensures that management operates in the best interests of the shareholders and that there is appropriate accountability to the organization's stakeholders (owners, workers, regulators, lenders). Corporate governance is important because it provides control to stakeholders; without it management would not be held accountable for its actions. An important aspect of governance is the audit committee of the board of directors. The audit committee improves corporate governance because it acts on behalf of stakeholders, yet has inside knowledge of the organization that those stakeholders cannot necessarily share.

Multiple Choice Questions:

2-25. d.
2-26. d. this is part of the profession's problem, but not a cause of the failure.
2-27. a.
2-28. d.
2-29. a.
2-30. d.
2-31. d.
2-32. d.
2-33. f.
2-34. c.
2-35 a.

Discussion and Research Questions:

2-36.

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 and quality financial reporting.
- 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.

2-37.

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:

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.
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	• 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.	
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 • Implementing quality control processes to ensure audit quality. • Educating members on audit and accounting requirements.	• 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 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.
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Party	Overview of Responsibilities	Overview of Corporate Governance Failures
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External Auditors	**Broad Role:** Performing audits of company financial statements to ensure 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.	• Pushed accounting concepts to the limit to help organizations 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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Party	Overview of Responsibilities	Overview of Corporate Governance Failures
	management, (including operational management), and audit committees, • Evaluating internal controls.	committee. • In some instances (HealthSouth, WorldCom) did not have access to the corporate financial accounts.

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 a lower level 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.

2-38.

Factors	**Explain Your Reasoning and the Implications 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

Factors	Explain Your Reasoning and the Implications of Poor Governance
	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 community members – one is the President of the Chamber of Commerce and the other is a retired executive from a successful local manufacturing firm.	This is a strong indicator of poor corporate governance. If the audit committee meets only twice a year, it is unlikely that it is devoting appropriate amounts of time to its oversight function, including reports from both internal and external 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. This is an example of poor governance because (1) it signals that the organization has not made a commitment to independent oversight by the audit committee, (2) the lack of financial expertise means that 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. However, the reporting relationship is not ideal. Further, 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 (top 5% for this institution).	The auditor should observe the minutes of the loan committee to verify its meetings. The auditor should also interview the chairman of the loan committee to understand both its policies and its attitude towards controls and risk. There are a couple of elements in this statement that carries great risk to the audit and to 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.

2-39.

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 include:
   - 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.

2-40.

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, to provide oversight of auditors of public companies. Further, 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 in meeting 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.

2-41.

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.

2-42.

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 auditor's "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.

2-43.

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 regulation. 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.

2-44.

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.

2-45.

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.

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*: 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.

Disapproval: 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.

Disapproval: 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.

Disapproval: 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:** *Disapproval: 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:** *Approval:* This is not a conflict of interest as it is an audit or assurance service.

6. **Train Operating Personnel on Internal Controls:** *Approval:* 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.

   Disapproval: 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:** *Disapproval:* 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.** *Approval:* 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.** *Approval:* The key is whether the audit committee feels that it may lose some of its objectivity in performing its oversight role.

2-46.

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.

2-47.

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. 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 reporting. In addition, well-run companies are generally well-run on multiple dimensions, e.g., corporate governance and operational performance.

b. The Board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation. **Broad Role:** The major representative of stockholders to ensure that the organization is run according to the organization's charter and that there is proper accountability. **Specific activities include:** selecting management, reviewing management performance and determining compensation, declaring dividends, approving major changes, e.g., mergers, approving corporate strategy, overseeing accountability activities.

The broad role of the audit committee is to provide oversight of the internal and external audit function and the process of preparing the annual financial statements and public reports on internal control.

c. The relationship with the audit function is primarily one of oversight. The audit committee of the board would have the primary oversight responsibility. 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 is the primary client of the auditor and is responsible for hiring or firing an external audit firm.

d. 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.

e. The quality of corporate governance relates to management's integrity and trustworthiness, the importance that they place on controls and financial reporting, etc., all of which can be linked to the performance of the organization and the way in which the audit will be conducted. More risk on an engagement can result in additional work and more rigorous work.

f. 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, and
- 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 if/when materially misstated financial statements are issued. Therefore, auditors may choose to not accept a client with poor governance.

g. 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, and
- 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.

h. Principles presented in the chapter include:

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

i The principles associated with effective audit committees are presented in Exhibit 2.4. However, students may find other lists of audit committee principles published by other organizations.

2-48.

The goal of this assignment is to provide students with access to some of the GAO studies that have relevance to the class.

2-49.

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

2-50.

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.

2-51.

The goal of this exercise is to help students see that there is not one overall accepted list of best practices. However, students will likely find that many of the principles are similar across various lists. Further, this assignment helps students become familiar with organizations that are relevant to the corporate governance discussion. By requiring the students to develop their own "Top Ten" lists, students will need to be familiar with the purpose of governance as analyze the best approaches to accomplishing this purpose.

2.52.

This exercise illustrates that there are various ways to describe corporate governance and that there are some similarities across various definitions. Further, this assignment helps students become familiar with organizations and individuals that are relevant to the corporate governance discussion. When the students are required to draft their own definitions they recognize the need to fully understand the goals of governance, the parties involved and the approaches to achieving good governance.

2-53.

This exercise illustrates that the issue of corporate governance is a global issue. The insights the students will obtain will depend, in part, on the countries selected for research. For example, a report on Turkey would likely point out that: (1) there have been recent efforts to improve governance, in part, due to Turkey's efforts to join the European Union, (2) the concepts of transparency and disclosure are not well accepted by many companies because of their "family business" nature, etc.

2-54.

This exercise illustrates the fact that the approach to governance in the U.S. is not the only approach. Students will likely identify Germany as a country that uses a two tiered approach and will identify companies using a two tiered approach to include Siemens, ING, and Daimler. In terms of positive aspects of a two tiered structure students might note that the supervisory board is independent of management, meets often, devotes sufficient effort, has a great deal of power over management and the company, and operates on a near full time basis. In terms of less positive aspects, students might note that the board is more involved in the company than would be considered appropriate from a U.S. perspective. The discussion around which system might be more effective will likely draw on these positive and negative aspects.

2-55.

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.

2-56.

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

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

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

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

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

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

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

ACADEMIC RESEARCH CASE

Archambeault, D., DeZoort, F. T., Holt, T. (2008). The Need for an Internal Auditor Report to External Stakeholders to Improve Governance Transparency. *Accounting Horizons 22(4): 375-388.*

i. What is the issue being addressed in the paper?

The issue being addressed is the need for an internal audit report (IAR) to increase governance transparency for external stakeholders. Governance transparency is defined as the availability and extent of governance-related disclosures. The internal audit function is critical to the corporate governance of a company, as it provides assurance and ongoing assessments of the company's risk management processes and systems of internal control. Internal stakeholders have access to the information provided by internal audit. However, external stakeholders do not. This asymmetry raises the concern that corporate governance is not transparent to the external stakeholders and that this may represent an information risk to them. A commitment to an increase in the transparency of corporate governance is believed to result in an increase in trust and confidence with shareholders and stakeholders. This research is being performed to determine if the external stakeholders would benefit from additional information that could be provided to them in an IAR, what information they would benefit from, and if the benefit received would outweigh the cost of providing such information.

ii. Why is this issue important to practicing auditors?

The legal liability for internal auditors may increase as a result of the potential to become more accountable for the performance of an internal audit. Additional requirements for performance of the audit could result in loss of flexibility in determining the scope of the internal audit as necessary for a specific company. The IAR would not only highlight the work that the internal auditor is doing, but it would also highlight what internal audit is not doing. However, the requirement of an IAR could also provide the internal audit profession additional leverage that would increase internal auditor value within the corporate world, as well as the audit profession itself.

iii. What are the findings of the paper?

The results of the interviews that were conducted definitely indicate that an IAR has the potential to improve external stakeholder understanding of the internal audit function and corporate governance. As a result, corporate governance would be more transparent to the external stakeholders. The interview results indicate that increased transparency may lead to increased quality standardization of and investment in internal audit activities. The IAR would provide the external stakeholders with information about what is and is not being audited within the company. This would provide external stakeholders with an increased confidence in the information that they are being provided.

Increased cost considerations determined in the interviews included increased legal exposure for internal auditors as they would be held more accountable for their performance as well as more accountable for financial reporting failures. This increased liability could affect availability of qualified auditors as well as their desired compensation as a result of the increased liability. Increased information load for users is another cost concern. The

corporate disclosure is already lengthy and complex; the concern was expressed that users may not be able to fully understand the report. Additional reporting costs were not viewed as being a major issue if the internal auditor is doing a thorough job already but that there was the concern of increased risk due to limitations on audit scope as a result of not wanting to disclose results.

The IAR should include information that will provide valuable insight of the internal audit function to the external stakeholders. Some of the suggested information that should be included is the composition of the internal audit department, as well as their responsibilities, accountability, activities, and resources. The majority of the interviewees did not feel that an actual audit opinion was necessary as it would basically be the same as the opinion over internal controls.

iv. What are the implications of these findings for audit quality (or audit practice) on the audit profession?

An internal audit report supplied to external stakeholders could have several implications on audit quality. The report would potentially increase the accountability of the internal auditor, providing the auditor an incentive to apply more diligent care to the audit itself, therefore increasing the quality of the audit. The increased accountability and public review could provide the internal audit group with leverage for asking for critical resources and access within the company. Management would potentially have more incentive to provide the additional support and access that is requested. Another implication to the audit quality would be that the increase in accountability may lead the auditor to limit the scope of their audits due to having to disclose the results which would result in a decrease in audit quality. Further, as the quality of the internal audit function is affected, there are implications for external auditors who may choose to rely on the work of the internal auditors when performing the financial statement audit.

v. Describe the research methodology used as a basis for the conclusions.

Data was gathered by conducting 18 semi-structured interviews which averaged 20 minutes in length. A semi-structured interview format was used to allow new topics and questions to be introduced by the interviewees. The interviewees were selected using a convenience sampling. The interviewees consisted of four audit committee members (including 2 audit committee chairs), three analysts from investment firms, five internal auditors (including three CAE's), two members from the AICPA, 2 members from HA, and 2 members from the SEC. All participants had a minimum of ten years experience with governance and audit related issues.

The authors also reviewed relevant literature to gain insights on issues related to disclosures made via an IAR.

vi. Describe any limitations of the research that the student (and practice) should be aware of.

The student (and practice) should be aware that the research for this paper did not

consider the extent to which external stakeholders deduce adequate information about the internal audit function from current governance disclosures. Additional research is also needed to determine the costs and benefits derived from various wordings on an IAR within a mandatory versus voluntary environment.

Research is not an exact science. We look for the soundness of the research to uncover patterns of behavior that is demonstrated within the audit profession. Then we have to look for indications of how the audit practice should be influenced by the results.

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 and Kennesaw State University. 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.
If you are looking for a semester project using these materials, one of the instructors always assigns a semester paper that is completed in small groups (with 15 minutes of class time used each class period for group discussion, along with the expectation that groups will also meet periodically outside of class). For this project, the instructor assigns each of the questions for the chapters that are covered in the syllabus. Below, we reproduce the grading criteria and student instructions related to that project. Perhaps you will find this useful as a basis for constructing a similar project of your own.

FORD AND TOYOTA GROUP PAPER DESCRIPTION

The purpose of this group paper is to summarize your in-class discussions of the Ford and Toyota materials. The case is worth 100 points and will be due the last day of class. Note the following:

1. There is no page limit. Simply type up your answers (single space text is appropriate, and please use 12cpi font) to each class assignment as we proceed throughout the course. Keep them in a file and hand them in at the end of the course.
2. Your group will have three to five members.
3. Start a new class day/assignment on a new page of paper.
4. The text of your responses should address the assigned questions. Assign one group member per class day/assignment to be a note-taker, and that person will also be responsible for updating the "master" file.

Note: The questions are located at the end of each chapter in the book, immediately following the homework problems.

Answers to Chapter 2 Questions:

1a. Describe the history of Ford, its 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 (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).

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 in 2010?

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

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

Stephen G. Butler, Kimberly A. Casiano, Anthony F. Earley, Jr., Richard A. Gephardt, Irvine O. Hockaday, Jr., Richard A. Manoogian, Ellen R. Marram, Homer A. Neal, Gerald L. Shaheen, and John L. 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.

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 non-employee board members compensated? Could the nature of the compensation potentially affect the director's independence? Explain.

The Board of Directors has agreed that the following compensation will be paid to non-employee directors of the Company:

- $200,000 per annum
- $5,000 Committee chair fee
- $10,000 Presiding director fee

Importantly, a significant portion of non-employee director compensation is required to be tied to shareholders' interests and, therefore, 60% ($120,000) of a director's annual Board membership fee is paid in deferred common stock.

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. 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. Thus, Ford is trying to balance immediate cash payments that are reasonably high (in order to attract and retain high quality directors), while still aligning board members' long-term interests with those of shareholders. Ford's decisions in this regard are consistent with other similar companies. That is, they usually include some mix of immediate cash payments and long-term stock grants or options.

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

Ford's audit committee has four members, all of whom are independent. The audit committee met 12 times in 2009. 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. In the case of Ford, the other three audit committee members have high-level management experience (two were presidents of large companies), but they do not seem to have significant financial accounting experience, which may be inadequate for understanding Ford's complex financial accounting issues.

4c. Review the audit committee's report and describe its primary contents.

The report contains information about audit fees and auditor independence.

5a. Who is the auditor for Ford? Who is the auditor for Toyota?

PricewaterhouseCoopers LLP is the auditor for both companies.

5b. What were the Ford 2009 audit fees as a percentage of (a) total revenue, and (b) total assets?

5c. What were the Toyota 2009 audit fees as a percentage of (a) total revenue, and (b) total assets? Compare these amounts to those for Ford and discuss possible reasons for and implications of the differences.

	Audit fees	**% of Revenue**	**% of Assets**
Ford	$42,700,000	42,700,000/ 105,893,000,000=0.0004	42,700,000/ 194,850,000,000=0.0002
Toyota	¥3,072,000	3,072,000/ ¥18,950,973=0.0002	3,072,000/ ¥30,349,287=0.0001

Ford's fees are about double Toyota's on a percentage basis. Potential reasons for this difference are cost differences in conducting an audit in Japan versus the US (e.g., litigation and personnel costs) and differences in the riskiness of the two companies. In addition, Ford does have significant post-retirement benefits or OPEB's that have to be separately audited by PwC, whereas Toyota does not. Implications of these differences are that fewer hours would be needed to conduct the Toyota audit compared to the Ford audit, assuming that profitability targets are similar across geographic locations of PwC.

5d. Audit fees were not always publicly disclosed. In fact, such disclosure only became mandatory since the year 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.

6a. The Sarbanes-Oxley Act of 2002, Section 302, modified the requirements in the Exchange Act rules such that, effective starting in 2002, principal executive officers of publicly traded companies must certify their companies' financial statements and internal control processes. Read the officer certifications in Ford's Exhibits 31.1, 31.2, 32.1 and 32.2. What are your impressions of these disclosures?

Each group's answer will differ, but the main point is to get students to actually read these disclosures so that they know they exist, and they know the contents.

6b. Obtain a copy of the Sarbanes-Oxley Act of 2002. What are the specific certifications required in SOX Section 302?

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 Congress felt that it was necessary to require executive officers to make affirmative claims such as those found in Ford's 10K Exhibits 31 and 32?

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 its 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.

8a. 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.

8b. 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.

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 employees 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

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[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. <u>Corporate Opportunities</u>.

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. <u>Confidentiality</u>.

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. <u>Compliance with laws, rules and regulations; fair dealing</u>.

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