Learning Objectives

1. Identify the types of problems that can appear in financial statements.
2. Describe the safeguards employed within a firm to ensure that financial statements are free from problems.
3. Understand the concept of earnings management and why it occurs.
4. Understand the major parts of the Sarbanes-Oxley Act and how it impacts financial reporting.
5. Describe the role of auditors and how their presence affects the integrity of financial statements.
6. Explain the role of the Securities and Exchange Commission in adding credibility to financial statements.
Until 2002, WorldCom, a telecom giant, appeared to be one of the greatest corporate success stories ever. In 1983, a group of partners led by former basketball coach Bernard Ebbers sketched out their idea for a long distance telephone company on a napkin in a coffee shop in Hattiesburg, Mississippi. Soon after, their company LDDS (Long Distance Discount Service) began providing service as a long distance reseller. For 15 years, it grew quickly through acquisitions and mergers. Bernard Ebbers was named CEO in 1985, and the company sold shares of stock to the public in August 1989. Its $40 billion merger with MCI in 1998 was the largest corporate merger in history at the time.

The company was a favorite with investors and Wall Street analysts. The stock reached a peak of $64.51 per share in June 1999. At that time, CEO Bernard Ebbers was listed by Forbes Magazine as one of the richest men in the United States. Michael Jordan, the famous professional basketball player and most popular athlete in the world, provided commercial endorsements for WorldCom.

In October 1999, WorldCom attempted to purchase SPRINT in a stock buyout for $129 billion in stock and debt. The deal was vetoed by the Department of Justice. Even without the Sprint merger, by 1999, WorldCom owned a third of all U.S. data cables, which handled over 50% of all U.S. Internet traffic and e-mails worldwide, owned the 2nd largest long distance operator, MCI, and had over 20 million customers.

At the same time, however, the success of the company began to unravel with the accumulation of debt and expenses, the fall of the stock market, and drops in long distance rates and revenue. While it would take nearly two years for the extent of these problems to become public, in the end, WorldCom disclosed massive financial statement fraud and filed for Chapter 11 bankruptcy. In 2002, WorldCom became a horror story that involved the fall of the stock market, and drops in long distance rates and revenue. While it would take nearly two years for the extent of these problems to become public, in the end, WorldCom disclosed massive financial statement fraud and filed for Chapter 11 bankruptcy. In 2002, WorldCom became a horror story that involved the fall of the stock market, and drops in long distance rates and revenue.

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While there were several different types of financial statement frauds committed by WorldCom, by far the largest was the manipulation of expenses and assets. In a court filing in New York in November 2002, the Securities and Exchange Commission (SEC) said that WorldCom admitted that it concealed over $9 billion in expenses, all of which was converted into false profits.

As you learned in earlier chapters, expenditures should be classified as assets and listed on the balance sheet if they have future value, such as expenditures for buildings or equipment. If expenditures are for current operating costs such as salaries or rent, however, you learned that they should be expensed as incurred and reported as expenses on the income statement.

In simple terms, instead of expensing costs that had been incurred, the company was capitalizing those costs and putting them on the balance sheet. These expenditures should have been subtracted from revenues on the income statement and reported as expenses when incurred. The result was that reported expenses were lower than they should have been on the income statement and reported assets and owners’ equity were higher than they should have been on the balance sheet. Essentially, what WorldCom was doing was the equivalent of buying paper clips and recording them as buildings.

This hiding of expenses by accounting for them as assets and pushing operating costs into the future gave the appearance of high profits. This apparent profitability pleased investors who pushed the stock up to a high of $64.51 in June 1999. Reported profits in 2001 alone were $1.38 billion when in reality the company was experiencing and should have reported a loss.

The simple WorldCom fraud was discovered when some obscure tips provided to the company’s internal auditors were pursued by Cynthia Cooper, Gene Morse, and Glyn Smith, all internal auditors working for the company. At the same time, the SEC started an investigation into WorldCom’s profitability, wondering how WorldCom could be so profitable at the same time other telecom companies were losing money. The following sequence of events details WorldCom’s quick downfall:

- June 20, 2002—The internal auditors explained the financial statement frauds to the company’s audit committee.
- June 25, 2002—WorldCom publicly announced that it had inflated profits by over $3.8 billion for the previous five quarters (a number that would grow to over $9 billion).
- June 26, 2002—Several civil suits were filed against the company and its auditors, and trading in the company’s stock was halted.
- July 21, 2002—The company declared bankruptcy. The fraud eventually cost over 17,000 people their jobs.

At a subsequent hearing, David Myers, an accountant with WorldCom, stated: “I was instructed on a quarterly basis by Scott Sullivan, chief financial officer, to ensure that entries were made to falsify WorldCom’s books to reduce WorldCom’s reported actual costs and therefore to increase WorldCom’s reported earnings.” He said that Scott Sullivan and he would “. . . work backward,
picking the earnings numbers that they knew Wall Street analysts expected to see, and then force WorldCom’s financials to match those numbers.” While these shenanigans worked for a time, in the end, WorldCom’s total market value (number of shares of stock times stock price) went from a high of about $120 billion to almost nothing and several individuals were indicted for fraud.

In Chapters 1 and 2, you were introduced to financial accounting and shown the outputs (financial statements) of the financial reporting process. You learned that the balance sheet, income statement, and statement of cash flows are reports used by organizations to summarize their financial results for various users. In Chapters 3 and 4, the accounting cycle, the method of entering and processing financial transaction information in the accounting records, was described. You learned that transaction data are captured by journal entries, journal entry data are summarized in accounts and ledgers, ledger information is summarized on trial balances, and trial balance information provides the basis for the balance sheet, income statement, and statement of cash flows. In Chapter 5, you learned how financial statement information is used by comparing ratios over time for the same company or by comparing ratios across companies at the same point in time.

In Chapters 1 through 5, the assumption was made that the financial reporting process always works the way it should and that the resulting financial statements are accurate. In reality, however, because of unintentional errors, as well as intentional deception or fraud (such as in the WorldCom case), the resulting financial statements sometimes contain errors or omissions that can mislead investors, creditors, and other users.

In this chapter, we show how financial statements might be manipulated, and we discuss the safeguards built into the financial reporting system to prevent these abuses. We also examine the role that auditors play in ensuring that the financial statements fairly represent the financial performance of the firm.

The Types of Problems That Can Occur

Identify the types of problems that can appear in financial statements.

Obviously, most businesses do not engage in massive frauds like those that occurred at WORLDCOM. Financial deception does not come about mainly for two reasons: (1) the vast majority of business managers are honest, possess integrity, and would not be associated with fraudulent activity, and (2) safeguards have been built into the accounting system to prevent and detect activities that are inconsistent with the objectives of a business. These safeguards attempt to eliminate problems from being introduced into the financial statements. However, during the past few years, there have been numerous financial statement frauds disclosed at companies such as ENRON, WORLDCOM, ADELPHIA, GLOBAL CROSSING, XEROX, QUEST, WASTE MANAGEMENT, CENDANT, ANICOM, HOMESTORE, SUNBEAM, TYCO, and others.

Before proceeding further, we need to make an important distinction regarding these problems. Problems in the financial statements can result for several different reasons.

1. Errors—result when unintentional mistakes are made in recording transactions, posting transactions, summarizing accounts, and so forth. Errors are not intentional and when detected are immediately corrected. Errors can result from sloppy accounting, misinformation, miscalculations, and other factors.
2. **Disagreements**—result when different people arrive at different conclusions based on the same set of facts. Because accounting involves judgment and estimates, opportunities for honest disagreements in judgment abound. These disagreements often come about because of the different incentives that motivate those involved with producing the financial statements. An example of a disagreement might be differing views about what percentage of reported receivables will be collected or how long equipment and other assets will last.

3. **Frauds**—result from intentional errors. Fraudulent financial reporting occurs when management chooses to intentionally manipulate the financial statements to serve their own purposes, such as meeting Wall Street’s earnings forecasts as was the case with WorldCom. An accounting system should be designed to significantly reduce the possibility that problems, in whatever form, will make their way into financial statements.

### Types of Errors in the Reporting Process

Errors, and other problems, can occur in most stages of the accounting cycle. We will first describe the kinds of errors that can occur and then identify controls to minimize these errors.

#### Errors in Transactions and Journal Entries

Transactions, such as selling products or services, paying salaries, buying inventory, and paying taxes, are entered into the accounting records through journal entries. For example, if $5,000 is paid to an attorney for legal services, the following journal entry is made:

<table>
<thead>
<tr>
<th>Legal Expense</th>
<th>5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>5,000</td>
</tr>
</tbody>
</table>

*Paid an attorney $5,000 for legal services.*

An invoice from the law firm should support this entry. Errors could be introduced into the financial reporting process if (1) the invoice from the law firm was lost and the legal expense was not entered into the accounting records, (2) the amount entered into the accounting records was incorrect, or (3) the accounts involved were incorrectly identified.

#### Errors in Accounts and Ledgers

Even when journal entries properly summarize legitimate transactions, errors and misstatements can be introduced into the financial records because journal entry data are not summarized appropriately or accurately in the ledgers. Using the previous example of paying an attorney $5,000, errors could occur at the posting stage of the accounting cycle if the legal expense is entered in the wrong account in the ledger or if an incorrect amount is posted to the correct account. Posting the correct amount to the wrong expense account would result in the correct total for all expenses, but individual expense account balances would be incorrect.

A more severe error occurs at the ledger stage if amounts that should be included in asset or liability accounts are improperly included in expense or revenue accounts, or vice versa. Examples include (1) recording insurance expense as prepaid insurance (an asset), (2) recording purchases of goods for resale as inventory (an asset) when they should be reported as cost of goods sold (an expense), (3) recording money received from customers as revenue when it should be recorded as unearned revenue (a liability), or (4) not reporting supplies used as an expense.

#### Disagreements in Judgment

Many think that the accounting profession involves exactness and precision and that the accountant simply records the facts, totals the numbers, and presents unbiased results. Nothing could be further from the truth. Accountants are constantly making judgments and estimates.
regarding the past and the future. Let’s return to the landscaping business that we introduced in Chapters 3 and 4 to illustrate some of the judgments involved in the accounting process.

As your lawn care and landscaping business has become more and more successful, you have been able to obtain bigger and better jobs. Recently, you signed a contract to provide all the landscaping for a new condominium complex currently under construction. The terms of the contract call for payment of one-half of the contract amount up front and the remaining one-half upon completion. You begin working on the condominium landscaping in early December, but it looks as though you will not finish until well into January. To prepare financial statements at the end of the year, how much of the condominium contract should you report as revenue? Well, that depends on how close to completion the job is. If you are 25% complete, it makes sense to report 25% of the contract amount as revenue. If you are 75% complete, report 75% of the contract amount as revenue. The hard part is determining how much of the job has been completed.

Suppose you contact two landscapers (friendly competitors) and ask them to provide you with an estimate of how complete the landscaping job is at year-end. Would it be possible for these two people to arrive at different conclusions regarding the percentage of completion? Which one would be right? Different people can look at the same set of facts and arrive at different conclusions. They’re not wrong, just different. In this case, the different estimates would result in different financial statement numbers. These different numbers could make the difference between your company showing a profit or reporting a loss.

Consider another example. Most of your customers pay promptly, but some take a little longer to pay. A few customers discontinue their lawn care service and never pay for some of the services they received. Your problem is that when you provide a service for a customer, you do not know if that customer will be a “prompt payer,” a “slow payer,” or a “no payer.” Recognizing that a certain percentage of your customers will be “no payers,” should you record a receivable (and a revenue) for the full amount of every sale? As you will learn in Chapter 7, most businesses recognize that a certain percentage of receivables will be uncollectible. How should you arrive at the amount of your receivables that won’t be collected? Is it possible that
your estimate will be slightly off? Could different people legitimately arrive at different estimates? Of course. These different estimates will then affect the results reported in the financial statements.

**Fraudulent Financial Reporting**

As mentioned previously, fraudulent financial reporting is intentional. To illustrate, consider the journal entry made previously related to legal expense. Assume that a company’s accountant embezzles $5,000 and prepares the following journal entry to conceal the fraud:

<table>
<thead>
<tr>
<th>Legal Expense</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>5,000</td>
</tr>
</tbody>
</table>

*Paid an attorney $5,000 for legal services.*

The accountant could prepare the journal entry without supporting documentation (e.g., an invoice) or create a fictitious invoice from a phantom law firm.

Unless someone is watching closely, the theft may go undetected. Because the accountant made a fictitious entry to Legal Expense, the accounting records appear to be correct, and the accounting equation still balances. Cash, an asset, is stolen, and the recognition of an expense results in owners’ equity being reduced by the same amount.

\[
\text{Assets (decreased by $5,000)} = \text{Liabilities} + \text{Owners’ Equity (decreased by $5,000)}
\]

In addition, sometimes amounts for which there are no legitimate transactions are added or deducted directly from financial statement balances. Examples are listing sales that don’t exist (as was the case with WASTE MANAGEMENT, the trash disposal company, which was making false entries to record revenues and receivables that overstated income by as much as 35% in 1996 and a total of $1.7 billion from 1992–1997); not recording sales returns or

Adam’s fraud went undetected until he became greedy and expanded his methods of embezzling. He was caught when a customer of the bank twice made interest payments of $10,000. Adam took the second $10,000 payment and deposited it in his own account at the bank. The customer, realizing the error, notified the bank. The search for the missing $10,000 revealed Adam’s thefts.

As a result of his fraud, Adam was sentenced to four years in prison and entered into a restitution agreement to repay the bank. The IRS also informed Adam that his embezzled funds were taxable, and since he hadn’t paid timely taxes, he owed fines, penalties, interest, and taxes totaling nearly $100,000.

When released from jail, Adam will probably spend the rest of his life paying back the bank and the IRS the $250,000 he now owes.

*All Business Environments in this chapter are real cases. In some instances, such as here, the names have been changed.*

**Source:** This case is from the video *The Red Flags of Fraud*, The Association of Certified Fraud Examiners, Austin, Texas.
uncollectible receivables (as was the case with the vacuum maker, Regina, which did not record the return of over 40,000 vacuums); and not recording various expenses, understating liabilities, and overstating assets such as inventory or receivables (as was the case with Phar-Mor, which overstated its assets by shipping products back and forth between stores when inventory was counted). Sometimes these types of mistakes are unintentional, but in many cases they are intentional.

STOP & THINK
Before reading about the safeguards designed to minimize the types of problems we have just discussed, can you think of things that could be done to ensure that errors, disagreements in judgment, and fraudulent financial reporting do not occur?

T O S U M M A R I Z E : The accounting cycle and resulting financial reports of most organizations are accurate and can be relied on. Nevertheless, unintentional errors, disagreements in judgment, and fraudulent financial reporting can occur in the accounting process, thereby producing erroneous financial reports.

Safeguards Designed to Minimize Problems

Accounting is a language just as is English. In the same way that a falsehood can be written in English, a misleading story can be expressed by financial statements. By far, the vast majority of financial statements are as accurate as possible, and the preparers are honest. Federal Express, the shipping company, for example, requires that its executives annually sign off on a code of ethics that gives assurances in writing that they have no conflicts of interest or know of no improprieties. The company’s policy requires that any employee involved in any kind of dishonesty be immediately terminated and prosecuted. According to FedEx’s policy, “...magnitude is not the issue. It doesn’t matter if the impropriety involves a thousand or a million dollars, our company will not tolerate anything that is done unethically or inappropriately.” Most organizations prepare accounting records and financial reports with integrity, and in most cases, preparers are even conservative when judgments and estimates are required. To help ensure that financial reports are accurate and to prevent problems such as those that occurred at WorldCom, several safeguards have been built into the financial reporting structure of most organizations in the United States. As a future user of accounting information, you should be aware of these safeguards and the reasons for their existence.

Most organizations build controls into their organization and financial reporting processes so that abuses are difficult. These safeguards, called the internal control structure, are internal to the organization preparing the financial statements. The American Institute of Certified Public Accountants (AICPA) has defined internal control as “the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved.” These internal controls protect investors and creditors and even help management in their efforts to run their organizations as effectively and efficiently as possible. When you encounter an organization or financial statements that do not have these controls and safeguards, you should exercise extreme care. Most companies have the following five concerns in mind when they are designing internal controls:

1. To provide accurate accounting records and financial statements containing reliable data for business decisions.
2. To safeguard assets and records. Most companies think of their assets as including their financial assets (such as cash or property), their employees, their confidential information, and their reputation and image.
3. To effectively and efficiently run their operations, without duplication of effort or waste.

1 AU Section 319, par. 06, Codification of Statements on Auditing Standards, CCH Inc., 1994, p. 98.
4. To follow management policies.
5. To comply with the Foreign Corrupt Practices Act, which requires companies to maintain proper record-keeping systems and controls.

The responsibility for establishing and maintaining the internal control structure belongs to a company’s management. Until several years ago, this responsibility was only implied; there was no formal legal requirement. However, in the wake of illegal political campaign contributions, business frauds, and numerous illegal payments to foreign officials in exchange for business favors, in 1977, Congress passed the Foreign Corrupt Practices Act (FCPA). As a result of this legislation, all companies whose stock is publicly traded are required by law to keep records that represent the firm’s transactions accurately and fairly. In addition, they must maintain adequate systems of internal accounting control. Following the rash of reported financial statement frauds in 2001 and 2002, Congress passed the Sarbanes-Oxley Act (known as the corporate responsibility act) in 2002. This far-reaching corporate reform act requires, among other things, that every company’s annual report contain an “internal control report,” which must (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and (2) contain an assessment of the effectiveness of the internal control structure. (This act, by the way, requires that the CEO and CFO of every public company prepare and sign a statement to accompany their financial statements that certifies the “appropriateness of the financial statements and disclosures contained in the report.”)

A company’s internal control structure can be divided into five basic categories: (1) the control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring. In this chapter, we will only briefly cover the control environment and control activities (sometimes called control procedures), as well as the need for monitoring (the areas of risk assessment and information and communication are left to courses covering the details of auditing). We will also discuss elements of accounting systems that are important from a control perspective.

The Control Environment

The control environment consists of the actions, policies, and procedures that reflect the overall attitudes of top management, the directors, and the owners about control and its importance to the company. In a strong control environment, management believes control is important and makes sure that everyone responds conscientiously to the control policies and procedures. Some of the key components of the control environment that relate to financial reporting are described below.

Management Philosophy and Operating Style

Does management set a good example by following controls? Do they stress the importance of controls to other employees? What is their management style? Are they, for example, risk averse or apt to take risks, dominated by one or two individuals or open to input from others, realistic or unrealistic about goals?

An example of a company with a poor management philosophy and operating style was ENRON. As you learned earlier in this book, Enron was a company that falsified its financial statements by hiding debt and other undesirable elements of the financial statements in off-balance sheet entities known as special purpose entities. Enron’s environment became extremely competitive and compromising to the point where lower-level managers, who saw that top management was manipulating the books, participated in dishonest actions that enriched themselves at the cost of the company. In Enron’s case, management was extremely dominant and dishonest; there were no clear lines of responsibility, budgets were unrealistic, and the company had no system of organizational checks and balances in place. Management’s dishonest actions led to a climate of moral decay that filtered throughout the organization, resulting in widespread abuse.
Organizational Structure

Does the organizational structure identify clear lines of authority and responsibility? Is the organizational structure so complex that dishonest transactions can be concealed?

An example of a complex organizational structure that was used to conceal a large fraud is the ESM COMPANY in Ohio. ESM was a brokerage business that bought and sold government securities. Over a period of seven years, the officers of the company funneled cash to themselves until the company owed approximately $300 million more in payables than it had in receivables. This net payable was concealed by setting up related entities and reporting a fictitious receivable from one of those companies in ESM Company's financial statements. If anyone had investigated the receivable, he or she would have found that the related company from which it was supposedly collectible was bankrupt.

Audit Committee

Every major company has a board of directors. A good control environment would suggest that a subset of these directors should form an audit committee. Generally, the audit committee should be comprised of outside directors (members of the board who are not officers of the company). The internal and external auditors would then be accountable to this audit committee. Under the Sarbanes-Oxley Act, members of the audit committee must be financially literate. The audit committee must be directly responsible for the appointment, compensation, and oversight of the work of the external auditor and must have the authority to engage independent legal counsel or other advisors if it suspects any wrongdoing.

External auditors who suspect wrongdoing in financial reporting should forward those concerns to the audit committee.

The Accounting System

The purpose of a company’s accounting system is to identify, assemble, classify, analyze, record, and report the entity’s transactions and to maintain accountability for assets. To be effective, the accounting system should contain adequate controls to ensure that seven control objectives are met.

1. Validity. Only valid transactions are recorded. If fictitious sales are recorded, for example, reported revenues will be too high, and the integrity of the financial statements will be lost.
2. Authorization. All transactions are properly authorized. If, for example, any employee could authorize purchases, a company might make duplicate purchases of the same items or purchase unneeded items.
3. Completeness. All legitimate transactions are recorded and the records are complete. If, for example, all liabilities are not recorded, a company will report a more favorable financial condition than actually exists.
4. Classification. All transactions are properly classified. For example, the current portion of long-term debt should be classified as a current liability. Incorrect classification would result in incorrect liability subtotals that would affect such ratios as the current ratio.
5. Timeliness. All transactions are recorded in the proper time period. A company might try to make its revenues and income look better than they are, for example, by recording early January sales in December.
6. Valuation. All transactions are properly valued. For example, if a receivable is uncollectible, it should not be classified as a current asset.
7. Posting and summarization. All transactions are properly included in subsidiary records and correctly summarized. Errors could occur, for example, if an accounts receivable entry was posted to the accounts payable account.

Control Activities (Procedures)

Control activities or control procedures are those policies and procedures, in addition to the control environment and accounting system, that management has adopted to provide reason-
able assurance that the company’s established objectives will be met and that financial reports are accurate. Generally, control activities fall into five categories: adequate segregation of duties, proper procedures for authorization, adequate documents and records, physical control over assets and records, and independent checks on performance.

**Adequate Segregation of Duties**

A good internal control system should provide for the appropriate segregation of duties. This means that no one department or individual should be responsible for handling all phases of a transaction. In some small businesses, this segregation is not possible because the limited number of employees prevents division of all the different functions. Nevertheless, there are three functions that should be performed by separate departments or by different people.

1. **Authorization.** Authorizing and approving the execution of transactions; for example, approving the sale of a building or land.
2. **Record keeping.** Recording the transactions in the accounting journals.
3. **Custody of assets.** Having physical possession of or control over the assets involved in transactions, including operational responsibility; for example, having the key to the safe in which cash or investment securities are kept or, more generally, having control over the production function.

By separating the responsibilities for these duties, a company realizes the efficiency derived from specialization and also reduces the errors, both intentional and unintentional, that might otherwise occur.

**Proper Procedures for Authorization**

A strong system of internal control requires proper authorization for every transaction. In the typical corporate organization, this authorization originates with the stockholders who elect a board of directors. It is then delegated from the board of directors to upper-level management and eventually throughout the organization. While the board of directors and upper-level management possess a fairly general power of authorization, a clerk usually has limited authority. Thus, the board would authorize dividends, a general change in policies, or a merger; a clerk would be restricted to authorizing credit or a specific cash transaction. Only certain people should be authorized to enter data into accounting records and prepare accounting reports.

As an example of journal entries and misstated financial statements that were not authorized, consider the following example:

In one of the large financial statement frauds that was disclosed in 2001, the CFO instructed the chief accountant to increase earnings by $105 million. The chief accountant was skeptical about the purpose of these instructions, but he did not challenge them. The mechanics were left to the chief accountant to carry out. The chief accountant created a spreadsheet containing seven pages of improper journal entries, 105 in total, that he determined were necessary to carry out the CFO’s instructions. These types of fictitious and unauthorized journal entries were made over a five-year period.

**Adequate Documents and Records**

A key to good controls is an adequate system of documentation and records. As explained in Chapter 3, documents are the physical, objective evidence of accounting transactions. Their existence allows management to review any transaction for appropriate
authorization. Documents are also the means by which information is communicated throughout an organization. In short, adequate documentation provides evidence that the recording and summarizing functions that lead to financial reports are being performed properly. A well-designed document has several characteristics: (1) it is easily interpreted and understood, (2) it has been designed with all possible uses in mind, (3) it has been prenumbered for easy identification and tracking, and (4) it is formatted so that it can be handled quickly and efficiently. Documents can be actual pieces of paper or information in a computer database.

### Physical Control Over Assets and Records

Some of the most crucial policies and procedures involve the use of adequate physical safeguards to protect resources. For example, a bank would not allow significant amounts of money to be transported in an ordinary car. Similarly, a company should not leave its valuable assets unprotected. Examples of physical safeguards are fireproof vaults for the storage of classified information, currency, and marketable securities; and guards, fences, and remote control cameras for the protection of equipment, materials, and merchandise. Records and documents are also important resources and must be protected. Re-creating lost or destroyed records can be costly and time-consuming, so companies make backup copies of records.

### Independent Checks on Performance

Having independent checks on performance is a valuable control technique. Independent checks incorporate reviews of functions, as well as the internal checks created from a proper segregation of duties.

There are many ways to independently check performance. Using independent reviewers, such as auditors, is one of the most common. In addition, mandatory vacations, where another employee performs the vacationing person’s duties, periodic rotations or transfers, or merely having someone independent of the accounting records reconcile the bank statement are all types of independent checks.

### TO SUMMARIZE:

Most organizations have an internal control system that, among other things, helps ensure integrity in financial reports. The various elements of control that relate to financial reporting are summarized as follows:

<table>
<thead>
<tr>
<th>Control Environment</th>
<th>Accounting System</th>
<th>Control Procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Organizational structure.</td>
<td>2. Properly authorized transactions.</td>
<td>2. Proper procedures for authorization.</td>
</tr>
<tr>
<td>3. Audit committee.</td>
<td>3. Completeness.</td>
<td>3. Adequate documents and records.</td>
</tr>
<tr>
<td></td>
<td>4. Proper classification.</td>
<td>4. Physical control over assets and records.</td>
</tr>
<tr>
<td></td>
<td>5. Proper timing.</td>
<td>5. Independent checks on performance.</td>
</tr>
<tr>
<td></td>
<td>6. Proper valuation.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>7. Correct summarization.</td>
<td></td>
</tr>
</tbody>
</table>

Public companies are required to include in their annual report a statement signed by management that describes and accepts responsibility for the internal controls of the company. The statement shown in Exhibit 1 was included in the 2002 annual report of IBM CORPORATION.

### Reasons for Earnings Management

#### 3 Understand the concept of earnings management and why it occurs.

Accountants, using the concepts of accrual accounting and the accounting standards that have been issued, add information value by using estimates and assumptions to convert the raw cash flow data into accrual data. However, the same flexibility that allows accountants to use pro-
Professional judgment to produce financial statements that accurately portray a company’s financial condition also allows desperate managers to manipulate the reported numbers.

This section describes four reasons for managing reported earnings. These aren’t necessarily good reasons. However, they do reflect the forces that are often spoken of as pushing managers to manipulate reported earnings. These four reasons are as follows:

• Meet internal targets.
• Meet external expectations.
• Income smoothing.
• Window dressing for an IPO or a loan.

Meet Internal Targets

Internal earnings targets are an important tool in motivating managers to increase sales efforts, control costs, and use resources more efficiently. But as with any performance measurement tool, it is a fact of life that the person being evaluated will have a tendency to forget...
the economic factors underlying the measurement and instead focus on the measured number itself.

**Meet External Expectations**

A wide variety of external stakeholders have an interest in the financial performance of a company. For example, employees and customers want a company to do well so that it can survive for the long run and make good on its long-term pension and warranty obligations. Suppliers want assurance that they will receive payment and, more importantly, that the purchasing company will be a reliable purchaser for many years into the future. For these stakeholders, signs of financial weakness, such as the reporting of negative earnings, are very bad news indeed. Accordingly, we shouldn’t be surprised that in some companies when the initial computations reveal that a company will report a net loss, the company’s accountants are asked to go back to the accrual judgments and estimates to see if just a few more dollars of earnings can be squeezed in order to get earnings to be positive.

**Income Smoothing**

Examine the time series of earnings for Company A and Company B shown in Exhibit 2. For Company A, the amount of earnings increases steadily for each year from Year 1 through Year 10. For Company B, the earnings series is like a roller coaster ride. Companies A and B have the same earnings in Year 1 and the same earnings in Year 10, and they also have the same total earnings over the 10-year period included in the graph. At the end of Year 10, if you were asked which company you would prefer to loan money to or to invest in, you would almost certainly choose Company A. The earnings stream of Company A gives you a sense of stability, reliability, and reduced risk.

Now, imagine yourself as the chief executive officer of Company B. You know that through aggressive accounting assumptions, you can strategically defer or accelerate the recognition of some revenues and expenses and smooth your reported earnings stream to be exactly like that shown for Company A. Would you be tempted to do so? Of course you would. The practice of
carefully timing the recognition of revenues and expenses to even out the amount of reported earnings from one year to the next is called **income smoothing**. By making a company appear to be less volatile, income smoothing can make it easier for a company to obtain a loan on favorable terms and to attract investors.

**Window Dressing for an IPO or a Loan**

For companies entering phases where it is critical that reported earnings look good, accounting assumptions can be stretched—sometimes to the breaking point. Such phases include just before making a large loan application or just before the initial public offering (IPO) of stock. Many studies have demonstrated the tendency of managers in U.S. companies to boost their reported earnings using accounting assumptions in the period before an IPO.

With all of the incentives to manage earnings, it isn’t surprising that managers occasionally do use the flexibility inherent in accrual accounting to actually manage earnings. And the more accounting training one has, the easier it is to see ways in which accounting judgments and estimates can be used to “enhance” the reported numbers. In fact, there have been nationwide seminars on exactly how to effectively manage earnings. One popular seminar sponsored by the National Center for Continuing Education in 2001 was titled, “How to Manage Earnings in Conformance with GAAP.” The target audience for the two-day seminar was described as CFOs, CPAs, controllers, auditors, bankers, analysts, and securities attorneys.

**The Earnings Management Continuum**

Not all earnings management schemes are created equal. The continuum in Exhibit 3 illustrates that earnings management can range from savvy timing of transactions to outright fraud. The discussion in this section discusses each activity on the earnings management continuum. Keep in mind that in most companies, earnings management, if it is practiced at all, does not extend beyond the savvy transaction timing found at the left end of the continuum in Exhibit 3. However, because of the importance, and economic significance, of the catastrophic reporting failures that are sometimes associated with companies that engage in more elaborate earnings management, the entire continuum is discussed here.

**Strategic Matching**

As mentioned in the earlier discussion of income smoothing, through awareness of the benefits of consistently meeting earnings targets or of reporting a stable income stream, a company can make extra efforts to ensure that certain key transactions are completed quickly, or delayed, in order for them to be recognized in the most advantageous quarter.

**Change in Methods or Estimates with Full Disclosure**

Companies frequently change accounting estimates respecting bad debts, return on pension funds, depreciation lives, and so forth. Although such changes are a routine part of adjusting

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**Exhibit 3: The Earnings Management Continuum**

<table>
<thead>
<tr>
<th>Savvy Transaction Timing</th>
<th>Aggressive Accounting</th>
<th>Deceptive Accounting</th>
<th>Fraudulent Reporting</th>
<th>Fraud</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strategic Matching</strong></td>
<td>Change in Methods or Estimates with Full Disclosure</td>
<td>Change in Methods or Estimates but with Little or No Disclosure</td>
<td>Non-GAAP Accounting</td>
<td>Fictitious Transactions</td>
</tr>
</tbody>
</table>
accounting estimates to reflect the most current information available, they can be used to manage the amount of reported earnings. Because the impact of such changes is fully disclosed, any earnings management motivation could be detected by financial statement users willing to do a little detective work.

**Change in Methods or Estimates with Little or No Disclosure**

In contrast to the accounting changes referred to in the preceding paragraph, other accounting changes are sometimes made without full disclosure. For example, in 1999 XEROX reported that the company changed the estimated interest rate used in recording sales-type leases without describing the change in the notes to the financial statements. While one might debate whether the new estimated interest rate was more appropriate, what is certain is that failing to disclose the impact of the change resulted in financial statement users being misled. These users evaluated the reported earnings of Xerox under the incorrect assumption that the results were compiled using a consistent set of accounting methods and estimates and could therefore be meaningfully compared to prior-year results. As indicated by the label in Exhibit 3, this constitutes deceptive accounting.

**Non-GAAP Accounting**

Toward the right end of the earnings management continuum lies the earnings management tool that can be politely called "non-GAAP accounting." A more descriptive label in many cases is "fraudulent reporting," although non-GAAP accounting can also be the result of inadvertent errors. For example, a brief description of some of ENRON's accounting practices was given in Chapter 1. It is clear that some (though certainly not all) of these accounting practices were established for the express purpose of hiding information from financial statement users. In so doing, Enron violated the spirit of the accounting standards. In some cases, Enron also violated the letter of the standards by using some accounting practices that were not allowed under GAAP.

**Fictitious Transactions**

As mentioned previously in this chapter, REGINA did not record the return of over 40,000 vacuums. In fact, the company rented secret warehouses in which to store returned merchandise in order to avoid recording the returns. This is an example of outright fraud, which is the deceptive concealment of transactions (like the sales returns) or the creation of fictitious transactions.

The five items displayed in Exhibit 3 also mirror the progression in earnings management strategies followed by individual companies. These activities start small and legitimate and really reflect nothing more than the strategic timing of transactions to smooth reported results. In the face of operating results that fall short of targets, a company might make some cosmetic changes in accounting estimates in order to meet earnings expectations, but would fully disclose these changes to avoid deceiving serious financial statement users. If operating results are far short of expectations, an increasingly desperate management might cross the line into deceptive accounting by making accounting changes that are not disclosed or by violating GAAP completely. Finally, when the gap between expected results and actual results is so great that it cannot be closed by any accounting assumption, a manager who is still fixated on making the target number must resort to out-and-out fraud by inventing transactions and customers. The key thing to remember is that the forces encouraging managers and accountants to manage earnings are real, and if one is not aware of those forces it is easy to gradually slip from the left side of the earnings management continuum to the right side.

**Is Earnings Management Ethical?**

Refer back to Exhibit 3. Everyone agrees that the creation of fictitious transactions, at the far right side of the earnings management continuum, is unethical. But there the universal agree-
ment ends with respect to what is and is not ethical. For example, managers and their auditors frequently disagree about what constitutes fraudulent, non-GAAP reporting. In the WORLDCOM example mentioned earlier, the company’s CFO vigorously defended the capitalization, rather than the expensing, of the disputed $3.8 billion in local phone access charges. The CFO reiterated this defense, based on his understanding of the appropriate accounting standards, in a multi-day series of meetings with the external auditor and the audit committee. In the view of the CFO, this “fraudulent reporting” was both ethical and in conformity with GAAP. And as one moves even further to the left on the earnings management continuum, disagreement about whether a certain act is or is not ethical increases. For example, when a company makes an accounting change, how can a bright line be drawn between sufficient and deceptive disclosure? And who is to judge whether the strategic timing of gains and losses by a company is unethical or just prudent business practice?

Exhibit 4 contains a figure called the GAAP oval. This oval represents the flexibility a manager has, within GAAP, to report one earnings number from among many possibilities based on different methods and assumptions. Clearly, reporting a number corresponding with points D or E, which are both outside the GAAP oval, is unethical. The difficult ethical question is whether the manager has a responsibility to try to report an earnings number exactly in the middle of the possible range, such as point B in Exhibit 4. Or does the manager have a responsibility to report the most conservative, worst-case number, like point A in the exhibit? Is it wrong for the manager to try to use accounting flexibility to report an earnings number corresponding with point C, which is the highest possible earnings number that is still in conformity with GAAP? And what cost is there, in terms of credibility, for a manager who makes a conservative set of accounting assumptions one year, perhaps when overall operating performance is good, and an aggressive set of assumptions the next year, perhaps to try to hide lackluster operating performance? Finally, note also that the boundary of the oval is fuzzy, so it sometimes is not clear whether a certain set of computations is or is not in conformity with GAAP.

Of course, whether a manager actually does manage earnings, and whether he or she crosses the line and violates GAAP to do so, is partially a function of the fear (and costs) of getting caught and of the general ethical culture of the company. But it is also a function of the personal ethics of the manager, and the manager’s ability to recognize that fraudulent and deceptive financial reporting is part of a continuum that

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**GAAP oval** A diagram that represents the flexibility a manager has, within GAAP, to report one earnings number from among many possibilities based on different methods and assumptions.

**F Y I:**

Nonaccountants are under the impression that there is no GAAP oval. Instead, they believe that there is only a GAAP point, a single quantity that represents the one, true earnings number. Managers must be aware that because of this attitude the public can be very unforgiving of companies that are found to have “innocently” managed earnings.

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**Exhibit 4: The GAAP Oval**
starts with innocent window dressing but can end with full-scale fraud. There is no neon sign giving a final warning saying, “Beware, don’t cross this line!” Thus, each individual must be constantly aware of where he or she is with respect to the earnings management continuum in Exhibit 3 and the GAAP oval in Exhibit 4. Boards of directors and financial statement preparers should also be aware that, as a group, managers are notoriously overoptimistic about the future business prospects of their companies. Therefore, a company policy of having a consistently conservative approach to accounting is a good counterbalance to managers who might try to justify optimistic accounting assumptions on the basis of a business turnaround that is “just around the corner.”

Personal Ethics

Personal ethics is not a topic one typically expects to study in a financial accounting course. However, the large number of accounting scandals in 2001 and 2002 demonstrated that personal ethics and financial reporting are inextricably connected. The GAAP oval in Exhibit 4 illustrates that there is a range of earnings numbers a company can report for a year and still be in strict conformity with GAAP. Thus, earnings management can and does occur without any violation of the accounting rules. If one takes a strictly legalistic view of the world, then it is clear that managers should manage earnings, when they have concluded that the potential costs in terms of lost credibility are outweighed by the financial reporting benefits, because earnings can be managed without violating any rules.

A contrasting view is that the practice of financial accounting is not a matter of simply applying a list of rules to a set of objective facts. Management intent often enters into the decision of how to report a particular item. For example, land is reported as a long-term asset in the balance sheet unless management intends to sell the land within one year of the balance sheet date. In the context of earnings management, an important consideration is whether savvy transaction timing or changes in accounting methods or estimates are done to better communicate the economic performance of the business to financial statement users or whether the earnings management techniques are used with the intent to deceive. And if earnings management is done to deceive, who is management trying to deceive? If management is trying to deceive potential investors, lenders, regulatory authorities, employees, or other company stakeholders, then managing earnings poses a real risk of lost credibility in the future. And there is one final important item to consider—most of us believe that intentionally trying to deceive others is wrong, no matter what the economic consequences.

TO SUMMARIZE: Because accounting earnings is a function of management’s estimates and assumptions, management can influence earnings. There are several reasons that management might manage earnings including pressure to meet internal earnings targets, pressure to meet external expectations, smoothing income, and preparing to receive a loan or to offer stock to the public. Earnings management can take the form of outright fraud or, more commonly, earnings management results from the careful application of rules and the careful timing of transactions. It is important that financial statement users recognize the pressures that can influence the reported earnings figures.

The Sarbanes-Oxley Act

4 Understand the major parts of the Sarbanes-Oxley Act and how it impacts financial reporting.

The Sarbanes-Oxley Act that was passed by Congress in 2002 was by far the most comprehensive legislation ever affecting the accuracy of financial reports. Because of its significance, it is important that you understand the highlights of this legislation. The effects of this legislation can be divided into three categories: the establishment of independent oversight of auditors, constraints on auditors, and constraints on company management.
Public Company Oversight Board

Sarbanes-Oxley required the establishment of a Public Company Accounting Oversight Board (PCAOB), with five full-time members, to oversee the accounting and auditing profession. This board is required to:

- Register all public accounting firms that provide audits for public companies.
- Establish standards relating to the preparation of audit reports for public companies.
- Conduct inspections (reviews) of accounting firms.
- Conduct investigations and disciplinary proceedings and impose appropriate sanctions on public accounting firms whose performance is inadequate.
- Enforce compliance with the Sarbanes-Oxley Act.

Constraints on Auditors

To ensure that external auditors remain independent, Sarbanes-Oxley requires the following:

- Accounting firms who audit public companies are prohibited from providing any non-audit services to their clients, including: (1) bookkeeping or other services related to the accounting records or financial statements, (2) financial information systems design and implementation, (3) appraisal or valuation services, (4) actuarial services, (5) internal audit outsourcing services, (6) management functions or human resources, (7) broker or dealer, investment adviser or investment banking services, (8) legal services and expert services unrelated to the audit, and (9) any other service that the Board determines is impermissible.
- Requires that audit partners on engagements be rotated off the audit every five years.
- Requires that auditors report to the audit committee rather than the CFO or other members of the company’s management.

Constraints on Management

Restoring public confidence in the financial reporting process will require that management ensure financial statement users of the steps taken to provide quality financial information. To that end, Sarbanes-Oxley requires management to do the following:

- The CEO and CFO of each public company are required to prepare a statement to accompany the audit report to certify to the appropriateness of the financial statements and disclosures. As discussed earlier, management is still required to provide an assessment of internal controls in each annual report.
- All public companies are required to develop and enforce an officer code of ethics.
- Loans to executive officers and directors are prohibited.
- Support a much stronger audit committee in each public company. The audit committee is a subset of the board of directors and consists only of individuals who are not part of the management team of the company.

Only time will tell how effective this law is in preventing and deterring financial statement misstatements. One thing is for sure, however, and that is that because of this legislation, public companies are taking their financial reporting responsibilities much more seriously than ever before.

To Summarize: Because of the rash of financial statement frauds, the Sarbanes-Oxley Act of 2002 provided sweeping legislative reforms that increased the responsibilities of public companies and their auditors in ensuring that financial reports are accurate.
The Role of Auditors in the Accounting Process

Describe the role of auditors and how their presence affects the integrity of financial statements.

**Internal Auditors**

Most large organizations have a staff of internal auditors, an independent group of experts in controls, accounting, and operations. This group’s major purpose is to monitor operating results and financial records, evaluate internal controls, assist with increasing the efficiency and effectiveness of operations, and detect fraud. The internal audit staffs in some large organizations include over 100 individuals. The audit manager reports directly to the president (or other high-level executive officer) and to the audit committee of the board of directors. By performing independent evaluations of an organization’s internal controls, the internal auditors are helping preserve integrity in the reporting process. Employees who know that internal auditors are reviewing operations and reports are less likely to manipulate records. Even if they do, their actions may be revealed by the work of the internal auditors.

Internal auditors’ responsibilities vary considerably, depending upon the organization. Some internal audit staffs consist of only one or two employees who spend most of their time performing reviews of financial records or internal controls. Other organizations may have a large number of auditors who search for and investigate fraud, work to improve operational efficiency and effectiveness, and make sure their organization is complying with various laws and regulations.

Organizations that have a competent group of internal auditors generally have fewer financial reporting problems than do organizations that don’t have internal auditors. An example of an industry that generally did not have effective internal audit staffs is the savings and loan industry, where many companies went bankrupt during the late 1980s. In many of those companies, managers who were committing fraud did not want internal auditors, who would have made it more difficult for management to manipulate financial statements. As you learned at the beginning of this chapter, it was the internal auditors who detected and investigated the financial statement fraud at WORLDCOM.

**External Auditors**

Probably the greatest safeguard in the financial reporting system in the United States is the requirement that firms have external audits. External auditors examine an organization’s financial statements to determine if they are prepared and presented in accordance with generally accepted accounting principles and are free from material (significant) misstatement. External audits are performed by certified public accounting (CPA) firms. CPA audits are required by the Securities and Exchange Commission and the major stock exchanges for all companies whose stock is publicly traded. Even companies that are not public, however, often employ CPAs to perform audits of their financial statements. Banks and other lenders usually require audits, and audits can instill confidence in users of financial reports. In conducting audits, CPAs are required by generally accepted auditing standards (GAAS) to provide reasonable assurance that significant fraud or misstatement is not present in financial statements. Because CPAs cannot audit every transaction of an organization, and because detecting collusive management deception is sometimes impossible, it is not possible for
auditors to guarantee that financial statements are “correct.” Instead, they can only provide reasonable assurance that financial statements are “presented fairly.” Even with audits, there are still a few occasions when major financial statement fraud is not detected. As we have already discussed in this chapter, the Sarbanes-Oxley Act of 2002 made major reforms in the way CPAs must conduct their audits, who they report to, and what their penalties are for not conducting proper audits.

CPA audits of financial statements have become very important in the United States because of the enormous size of many corporations. Because the stockholders, who own corporations, are usually different individuals from a company’s management, audits provide comfort to these owners/investors that management is carrying out its stewardship function appropriately.

What Do Auditors Do?

While management has the primary responsibility of ensuring that the internal control system is functioning properly, internal auditors provide an independent assessment of how well the controls are working. External auditors usually study the internal control system to see if they can rely on it as they perform their audits. After all, if the internal control system is functioning correctly, it increases the likelihood that the resulting financial information is reliable. Often the external auditors will rely on the assessment of the internal controls made by the internal auditors.

Auditors gain confidence in the quality of the reporting process using several different processes: interviews, observation, sampling, confirmation, and analytical procedures. Several of these processes are used by both internal and external auditors, while some are used primarily by external auditors. Exhibit 5 provides a summary of these procedures and indicates who uses them most often. A brief discussion of each process then follows.

Interviews
Auditors interview employees to ensure that procedures are understood, proper documentation is being made, and proper authorization is being obtained. Through interviews, auditors identify potential weaknesses in the control system that will be examined using testing procedures.

Observation
Observation is done to verify compliance with procedures and to ensure that accounting records agree with physical records. For example, auditors in a bank will count the cash in a vault to ensure that recorded amounts agree with the actual cash on hand. Auditors will also verify the existence of inventory by doing a physical count of product. In addition to using observation to verify the existence of assets, auditors will also use observation to ensure that employees are complying with proper procedures.

Exhibit 5: Audit Processes Used by Auditors

<table>
<thead>
<tr>
<th>Internal Auditors</th>
<th>External Auditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interviews</td>
<td>X</td>
</tr>
<tr>
<td>Observation</td>
<td>X</td>
</tr>
<tr>
<td>Sampling</td>
<td>X</td>
</tr>
<tr>
<td>Confirmation</td>
<td>—</td>
</tr>
<tr>
<td>Analytical procedures</td>
<td>—</td>
</tr>
</tbody>
</table>

Caution
Auditors are responsible for evaluating the assumptions and estimates of management as well as testing the internal control system. The auditors do not make the assumptions and estimates, nor are they responsible for designing the internal control system.
Sampling
As mentioned previously, auditors cannot examine every transaction. Typically, they will select a sample of transactions for analysis. Based on the results of their analysis of the sample, they may conclude that the internal control procedures are being complied with, resulting in reliable financial information. Auditors may also conclude from the results that the internal control system is not reliable, resulting in further testing being required.

Confirmation
Used primarily by external auditors, confirmations are used to verify the balances in accounts that result from transactions with outsiders. For example, customers are often contacted and asked to verify account balances. Banks are contacted to verify loan amounts, lines of credit, and other account balances. This procedure ensures that the balances listed on the financial statements do, in fact, exist.

Analytical Procedures
Analytical procedures are used to provide guidance to external auditors as they attempt to identify areas that may deserve attention. Analytical procedures involve the use of such techniques as comparative ratio analysis (the same ratio analysis we have discussed in Chapter 5). By comparing the results of ratio analysis from one period to the next, auditors may be able to identify areas where additional investigation may be appropriate.

At the completion of an audit, the auditors issue a report that accompanies the financial statements and describes to readers, in very general terms, what was done by the audit firm and whether accounting rules were followed; the report also indicates an opinion as to whether the financial statements and the accompanying notes fairly represent the financial condition of the firm.

As an example of an auditors’ report, MICROSOFT’s 2002 independent auditors’ report, taken from the company’s 2002 financial statements, is included in Exhibit 6.

Are Auditors Independent?
Auditors are hired by management to make sure that the financial statements prepared by management fairly represent the financial performance of the company. Since management is paying the auditors, is there a danger that the auditors may not be independent? Is there a possibility that auditors will go along with whatever management says because management is paying them? That possibility exists, but there are a number of factors that work as a counterbalance.

First, recall from our discussion of the internal control structure that the Foreign Corrupt Practices and Sarbanes-Oxley acts require companies to maintain an adequate system of internal controls. If management knowingly violate this law, they can go to jail (a number of top managers have) and would be subject to personal fines. In addition, the company is subject to corporate fines. Thus, management would be taking a big risk if they interfere with the auditors.

Second, external auditors have a responsibility to financial statement users to ensure that financial statements are fairly presented. The legal system in the United States provides auditors with financial incentives to remain independent. As an example, the auditors in the PHAR-MOR financial statement fraud case were sued by plaintiffs for over $1 billion. A jury held the audit firm liable, and that firm settled with the plaintiffs for a lesser, though undisclosed (but not insignificant), amount. Thus, external auditors are taking a big risk if they allow their independence and integrity to be compromised.

Third, auditors have a reputation to protect. The reason auditors are hired at all is because the investing public believes they provide an independent check on the reliability and integrity of the financial information. If an audit firm were no longer perceived in this manner, companies would cease to employ it. CPA firms obtain audit clients based on the quality of their reputation. Would they sell that reputation to the highest bidder? That would be very shortsighted indeed.
Knowing the incentives that influence auditors to provide fair and reliable financial information, we can now begin to see how the issues relating to disagreements in judgment can work themselves out. On the one hand, we have a management team that has an incentive to provide financial statement information that portrays the company in the most favorable position possible. On the other hand, we have auditors who are responsible to ensure that the information being provided is unbiased and fair. If auditors don’t live up to their charge, they can end up paying to litigants much more than they ever received in audit fees.

The Securities and Exchange Commission (SEC) and the new Public Company Accounting Oversight Board are working with public accounting firms to ensure that independence remains a keystone of the auditing profession.

If management is allowed to paint an overly optimistic picture of the firm’s performance by using estimates that bias the financial reports, the audit firm will pay (via litigation) if those estimates prove to be materially wrong in the future. To protect itself, the audit firm would actually prefer that management use conservative estimates, but management will not always go along with the auditors in this regard. It is this tension, resulting from differing incentives, that provides financial statement users with information that, taken as a whole, fairly represents the financial performance of a business.

Exhibit 6: Microsoft’s 2002 Independent Auditors’ Report

INDEPENDENT AUDITORS’ REPORT

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries (the Company) as of June 30, 2001 and 2002, and the related consolidated statements of income, cash flows, and stockholders’ equity for each of the three years in the period ended June 30, 2002. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Microsoft Corporation and subsidiaries as of June 30, 2001 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2002 in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the financial statements, the Company adopted Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, effective July 1, 2000, and Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, effective July 1, 2001.

DELOITTE & TOUCHE LLP
Deloitte & Touche LLP
Seattle, Washington

July 18, 2002

FYI: This give and take between the auditors and management typically results in financial statements that fairly reflect the financial performance of a business. For example, in 2001, of 7,421 audits conducted for firms listed on the New York, American, and NASDAQ stock exchanges, only 26 involved significant issues on which auditors and management could not reach agreement on disclosure.
Part 1  |  Financial Reporting and the Accounting Cycle

**TO SUMMARIZE:** Auditors provide a check and balance to ensure that the financial statements fairly reflect the financial performance of a business. Most large organizations have internal auditors whose role it is to ensure integrity in the financial records and to evaluate and encourage adherence to the organization’s internal controls. Internal auditors are a very effective deterrent to fraud by employees and to the overriding of controls by management. Integrity in the financial reporting process is ensured with independent audits of financial statements by external certified public accountants. Such independent financial statement audits are required for all public companies, and often by creditors and other users. While audits can’t “guarantee” accuracy in the financial statements, they do add credibility.

**The Securities and Exchange Commission**

6. Explain the role of the Securities and Exchange Commission in adding credibility to financial statements.

**Securities and Exchange Commission (SEC)** The government body responsible for regulating the financial reporting practices of most publicly owned corporations in connection with the buying and selling of stocks and bonds.

In addition to the role of independent internal and external auditors, the U.S. government plays a role in ensuring the integrity of financial information. The **Securities and Exchange Commission (SEC)** is responsible for ensuring that investors, creditors, and other financial statement users are provided with reliable information upon which to make investment decisions.

The SEC is an agency of the federal government. The SEC was organized in the 1930s because of financial reporting and stock market abuses. One such abuse was price manipulation. It was not uncommon in the 1920s for stockbrokers or dealers to indulge in “wash sales” or “matched orders,” in which successive buy and sell orders created a false impression of stock activity and forced prices up. This maneuver allowed those involved to reap huge profits before the price fell back to its true market level. Outright deceit by issuing false and misleading financial statements was another improper practice. The objective of these manipulative procedures was to make profits at the expense of unwary investors.

One classic example of a major fraud that may have contributed to the formation of the SEC is the Ivar Kreugar case. During the 1920s, the most widely held securities in the United States, and perhaps the world, were the stocks and bonds of KREUGAR & TOLL, INC., a Swedish match company. These securities were popular because they paid high dividends (over 20% annually) and were sold in small denominations, making them attractive to both large and small investors. Ivar Kreugar, known as the “Match King,” became wealthy and famous as a financial genius, building his business into a multibillion-dollar international enterprise. In fact, Kreugar defrauded millions of investors by personally creating false and misleading financial statements. Instead of being paid out of profits, the dividends were paid out of capital that was raised by selling securities to unsuspecting investors. Eventually, the giant pyramid collapsed, Kreugar committed suicide, and Kreugar & Toll, Inc., went bankrupt. On the day Kreugar died, his company’s stock was selling for $5 a share. Within weeks, it was selling for five cents a share. The American public was outraged, and some have speculated that this major fraud was instrumental in causing Congress to enact securities legislation to prevent such deception from happening again.

The Securities Act of 1933 requires most companies planning to issue new debt or stock securities to the public to submit a registration statement to the SEC for approval. The SEC examines these statements for completeness and adequacy before permitting companies to sell securities through securities exchanges. The Securities Exchange Act of 1934 requires all public companies to file detailed periodic reports with the SEC.

The SEC requires a considerable amount of information to be included in these filings. Among other things, a company must submit financial statements that have been audited by CPAs and that contain an opinion issued by those CPAs.
Of the many reports required by the SEC, the following have the most direct impact on financial reporting:

- **Registration statements.** These include various forms that must be filed and approved before a company can sell securities through the securities exchanges.

- **Form 10-K.** This report must be filed annually for all publicly held companies. The report contains extensive financial information, including audited financial statements by independent CPAs. The 10-K also requires additional disclosure beyond that typically provided in the audited financial statements. Examples of additional information include the executive compensation of top management and the details of property, plant, and equipment transactions.

- **Form 10-Q.** This report must be filed quarterly for all publicly held companies. It contains certain financial information and requires a CPA’s involvement.

Because the SEC has statutory power to mandate any reporting requirement it feels is needed, it has considerable influence in setting generally accepted accounting principles and disclosure requirements for financial statements. Generally, the SEC accepts the accounting pronouncements of the Financial Accounting Standards Board and other bodies such as the AICPA. In addition, the SEC has the power to establish rules for any CPA associated with audited financial statements submitted to the commission.

The SEC is given broad enforcement powers under the 1934 Act. If the rules of operation for stock exchanges prove to be ineffectual in implementing the requirements of the SEC, the SEC can alter or supplement them. The SEC can suspend trading of a company’s stock for not more than 10 days (a series of orders has enabled the SEC to suspend trading for extended periods, however) and can suspend all trading on any exchange for up to 90 days. If substantive hearings show that the issuer failed to comply with the requirements of the securities laws, the SEC can “de-list” any security. Brokers and dealers can be prevented, either temporarily or permanently, from working in the securities market, and investigations can be initiated, if deemed necessary, to determine violations of any of the Acts or rules administered by the SEC.

**The Effect of the 1934 Act on Independent Accountants**

Accountants are involved in the preparation and review of a major portion of the reports and statements required by the 1934 Act. Accountants also can be censured, and their work is subject to approval by the SEC. The financial statements in the annual report to stockholders and in the 10-K report must be audited. In addition, accountants consult and assist in the preparation of the quarterly 10-Q reports and the other periodic reports.

More recently, the Sarbanes-Oxley Act has strengthened the authority of the SEC to monitor financial reporting. Under the Act, the SEC is given more resources and authority, has oversight for the new Public Company Accounting Oversight Board, has more control over auditors and reporting companies, and, in general, has a greater responsibility to protect investors and creditors who rely on financial reports.

**TO SUMMARIZE:** The Securities and Exchange Commission is an agency of the federal government whose purpose is to assist investors in public companies by regulating stock and bond markets and by requiring certain disclosures. Although the SEC has statutory authority to establish accounting principles, it basically accepts pronouncements of the FASB and AICPA as authoritative. Common reports required by the SEC are registration statements and Forms 10-K and 10-Q. Because the SEC can suspend trading and even de-list securities, it is a powerful organization that significantly influences financial reporting in the United States.
Identify the types of problems that can appear in financial statements. Three types of problems can affect financial statements: (1) Errors involve unintentional mistakes that can enter the accounting system at the transaction and journal entry stage or when journal entries are posted to accounts. These errors, when detected, are immediately fixed. (2) Disagreements in judgment occur because of the differing incentives of those associated with the financial statements. While management may have an incentive to present an optimistic view of the company’s performance, auditors have an incentive to ensure full disclosure of all relevant issues. These differing incentives typically result in financial statements that fairly reflect the financial performance of the company. (3) Fraudulent financial reporting involves intentional misrepresentations in the financial statements. Safeguards are built into the accounting and reporting system to minimize the possibility that these problems will be reflected in the financial statements.

Describe the safeguards employed within a firm to ensure that financial statements are free from problems. Internal controls are safeguards built into an organization that help to protect assets and increase reliability of the accounting records. The three basic internal control structure categories are (1) the control environment, (2) the accounting systems, and (3) the control procedures. The five types of control procedures are (1) segregation of duties, (2) procedures for authorizations, (3) documents and records, (4) physical safeguards, and (5) independent checks. The control environment is comprised of such things as management’s philosophy and operating style, the organizational structure, and the audit committee.

Understand the concept of earnings management and why it occurs. Earnings management occurs when judgment in financial reporting and in structuring transactions is used to alter financial reports to influence the perceptions of stakeholders about the underlying economic performance of the company and/or to influence outcomes that depend on reported accounting numbers. The practice of earnings management may potentially affect the transparency of the underlying economic reality of a company’s financial performance or position to such an extent that decisions with respect to the allocation of resources may change in the absence of such a practice.

Understand the major parts of the Sarbanes-Oxley Act and how it impacts financial reporting. The Sarbanes-Oxley Act is the most significant and far-reaching legislation ever passed by Congress. The Act provides for a Public Company Accounting Oversight Board that will regulate and monitor both auditors and officers of public companies.

Describe the role of auditors and how their presence affects the integrity of financial statements. Most large organizations have internal auditors who are “independent” internal control experts. They examine the various functions and divisions of the business to evaluate internal controls, operating efficiency and effectiveness, and compliance with laws and company policy. Internal auditors usually report to top management or the board of directors and increase the reliability of financial statements by ensuring that internal controls function as they should.

External audits are required of most public companies by the Securities and Exchange Commission. By conducting audits of financial statements according to generally accepted auditing standards put into effect by the AICPA, external audits provide “reasonable assurance” that financial statements are presented fairly and are not materially misstated. External audits must be performed by CPAs who are licensed by the individual states in which they practice.

Explain the role of the Securities and Exchange Commission in adding credibility to financial statements. The SEC is the agency of the federal government charged with the responsibility of assisting investors by making sure they are provided with reliable information upon which to make investment decisions. The SEC was organized in the 1930s and requires certain periodic reports such as the Forms 10-Q and 10-K of companies that sell stock publicly in the United States. It adds credibility to financial statements by requiring independent audits, reviewing financial statements itself, and sanctioning firms that violate its standards.
Ensuring the Integrity of Financial Information

**key terms & concepts**

accounting system, 262  
audit committee, 262  
control activities (procedures), 262  
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**discussion questions**

1. How can a person tell whether an entry to an expense account is payment for a legitimate expenditure or a means of concealing a theft of cash?  
2. How would it be possible to overstate revenues? What effect would an overstatement of revenues have on total assets?  
3. What is the Foreign Corrupt Practices Act, and how is it important to financial reporting?  
4. What are the major elements of a system of internal controls?  
5. Identify five different types of control procedures.  
6. What are the four factors that might motivate a manager to attempt to manage earnings?  
7. (a) What is the purpose of internal earnings targets? (b) What is the risk associated with internal earnings targets?  
8. What is meant by the term income smoothing?  
9. What are the five labels in the earnings management continuum (see Exhibit 3), and what general types of actions are associated with each of the labels?  
10. Is there anything wrong with using a different accounting estimate this year compared to last year, as long as both estimates fall within a generally accepted range for your industry?  
11. Refer to the GAAP oval in Exhibit 4. (a) In what important way is point E different from point C? (b) In what important way is point A different from point C?  
12. The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board. Identify the duties of that board.  
13. What constraints were placed on auditors as a result of the Sarbanes-Oxley Act?  
14. As a result of the Sarbanes-Oxley Act, public companies are required to make changes in the way they do business. What practice does Sarbanes-Oxley forbid?  
15. How do internal auditors add to the credibility of financial statements?  
16. What is the purpose of a financial statement audit by CPAs?  
17. Do you believe that outside auditors (CPAs) who examine the financial statements of a company, while being paid by that company, can be truly independent?  
18. The SEC requires companies to register with it when they sell stocks or bonds and also requires periodic reporting thereafter. Which of these reports, the initial registration statements or the subsequent periodic reports, do you believe would be scrutinized more closely by the SEC?  
19. What do you suspect is the relationship between the FASB and the SEC?
Accounting Errors—Transaction Errors
How would the following errors affect the account balances and the basic accounting equation, \( \text{Assets} = \text{Liabilities} + \text{Owners' Equity} \)? How do the misstatements affect income?

a. The purchase of a truck is recorded as an expense instead of an asset.
b. A cash payment on accounts receivable is received but not recorded.
c. Fictitious sales on account are recorded.
d. A clerk misreads a handwritten invoice for repairs and records it as $1,500 instead of $1,800.
e. Payment is received on December 31 for the next three months’ rent and is recorded as revenue.

Errors in Financial Statements
The following financial statements are available for SHERWOOD REAL ESTATE COMPANY:

<table>
<thead>
<tr>
<th>Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Receivable from sale of real estate</td>
</tr>
<tr>
<td>Interest receivable*</td>
</tr>
<tr>
<td>Real estate properties</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stockholders’ Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital stock</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
</tr>
</tbody>
</table>

Total assets | $11,181,300 |
Total liabilities and stockholders’ equity | $11,181,300 |

*Interest Receivable applies to Receivable from sale of real estate.

<table>
<thead>
<tr>
<th>Income Statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on sale of real estate</td>
</tr>
<tr>
<td>Interest income*</td>
</tr>
<tr>
<td>Total revenues</td>
</tr>
<tr>
<td>Expenses</td>
</tr>
<tr>
<td>Net income</td>
</tr>
</tbody>
</table>

*Interest Income applies to Receivable from sale of real estate.

Sherwood Company is using these financial statements to entice investors to buy stock in the company. However, a recent FBI investigation revealed that the sale of real estate was a fabricated transaction with a fictitious company that was recorded to make the financial statements look better. The sales price was $5,000,000 with a zero cash down payment and a $5,000,000 receivable. Prepare financial statements for Sherwood Company showing what its total assets, liabilities, stockholders’ equity, and income really are with the sale of real estate removed.
**Exercise 6-3**

**Appropriateness of Accounting Rules**

In the early 1990s, the top executive of a large oil refining company (based in New York) was convicted of financial statement fraud. One of the issues in the case involved the way the company accounted for its oil inventories. In particular, the company would purchase crude oil from exploration companies and then process the oil into finished oil products, such as jet fuel, diesel fuel, and so forth. Because there was a ready market for these finished products, as soon as the company purchased the crude oil, it would value its oil inventory at the selling prices of the finished products less the cost to refine the oil. Although the case involved fraud, the type of accounting used was also questioned because it allowed the company to recognize profit before the actual sale (and even refining) of the oil. Nevertheless, one of the large CPA firms attested to the use of this method. If you were the judge in this case, would you be critical of this accounting practice?

**Exercise 6-4**

**Internal Control Procedures**

As an auditor, you have discovered the following problems with the accounting system control procedures of Jefferson Retailers. For each of the following occurrences, tell which of the five internal control procedures was lacking. Also, recommend how the company should change its procedures to avoid the problem in the future.

a. Jefferson Retailers’ losses due to bad debts have increased dramatically over the past year. In an effort to increase sales, the managers of certain stores have allowed large credit sales to occur without review or approval.

b. An accountant hid his theft of $200 from the company’s bank account by changing the monthly reconciliation. He knew the manipulation would not be discovered.

c. Steve Meyer works in the storeroom. He maintains the inventory records, counts the inventory, and has unlimited access to the storeroom. He occasionally steals items of inventory and hides the theft by including the value of the stolen goods in his inventory count.

d. Receiving reports are sometimes filled out days after shipments have arrived.

**Exercise 6-5**

**Internal Auditing—Staffing Internal Audits**

A manufacturing corporation recently reassigned one of its accounting managers to the internal audit department. He had successfully directed the western-area accounting office, and the corporation thought his skills would be valuable to the internal audit department. The director of the internal audit division knew of this individual’s experience in the western-area accounting office and assigned him to audit that same office.

Should the internal auditor be assigned to audit the same office in which he recently worked? What problems could arise in this situation?

**Exercise 6-6**

**Internal Auditing**

Which of the following is not applicable to the internal audit function?

a. Deter or catch employee fraud.

b. Issue an opinion for investors regarding the reliability of the financial statements.

c. Be guided by its own set of professional standards.

d. Help to ensure that the accounting function is performed correctly and that the financial statements are prepared accurately.

**Exercise 6-7**

**Internal Auditing—External Auditor’s Reliance on Internal Auditors**

North, CPA, is planning an audit of the financial statements of General Company. In determining the nature, timing, and extent of the auditing procedures, North is considering General’s internal audit function, which is staffed by Tyler.

1. In what ways may Tyler’s work be relevant to North?
2. What factors should North consider, and what inquiries should North make in deciding whether to rely on Tyler’s work?
Ensuring the Integrity of Financial Reporting

Three college seniors with majors in accounting are discussing alternative career plans. All three want to enter careers that will help to ensure the integrity of financial reporting. The first wants to become an internal auditor. She believes that by ensuring appropriate internal controls within a company, the financial statements will be reliable. The second wants to go to work in public accounting and perform external audits of companies. He believes that external auditors are independent and can make sure that financial statements are correct. The third student believes that neither choice will be adding much value to the integrity of financial statements because, in both cases, the auditors will be receiving their pay (either directly or indirectly) from the companies they audit. He believes the only way to make a real difference is to work for the Securities and Exchange Commission, using the “arm of government regulation” to force companies to issue appropriate financial statements and then punishing them (through jail sentences and large fines) when their financial statements are misleading. In your opinion, which of these three students will make the largest contribution toward ensuring integrity in the financial statements?

Exercise 6-9

External Auditors—Purpose of an Audit

What is the purpose of external auditors providing an opinion on a company’s financial statements?

Exercise 6-10

Auditing Financial Statements

The Utah Lakers professional basketball team has recently decided to sell stock and become a public company. In determining what it must do to file a registration statement with the SEC, the company realizes that it needs to have an audit opinion to accompany its financial statements. The company has recently approached two accounting students at a major university and asked them to “audit” its financial statements to be submitted to the SEC. Should the two accounting students accept the work and perform the audit?

Exercise 6-11

Securities and Exchange Commission—Authority to Set Accounting Standards

Which organization—the Securities and Exchange Commission, the American Institute of Certified Public Accountants, or the Financial Accounting Standards Board—has federal government authority to set accounting standards and reporting requirements? Some people have argued that all accounting rule making should be done by the federal government. Do you agree? Why or why not?

Exercise 6-12

Securities and Exchange Commission—Role of the SEC

Describe the role of the Securities and Exchange Commission and its influence on the practice of auditing.

Exercise 6-13

Securities and Exchange Commission—Information Needed for Investing

As an investor you are considering buying stock in a relatively new company. American Shipping, Ltd., has been in existence for 10 years and is now about to go public. The first stock offering will be listed on the New York Stock Exchange next week.

1. What kind of information would you like to know before investing in the company? Where can you find this information?
2. How does the SEC protect the securities market from companies that are fraudulent or in poor financial condition?
3. Besides stock market investors, what other parties might be interested in knowing financial data about companies?
Exercise 6-14

**Auditing Negligence**
A few years ago, the officers of PHAR-MOR, a discount retail chain, were convicted of issuing fraudulent financial statements. It was learned at the trial that the company overstated its inventory by moving inventory from store to store and counting the same inventory several times. For example, a case of Coca-Cola would be counted at one store and then moved to another store and counted again. In a separate civil trial, Phar-Mor’s auditors were accused of performing negligent audits because they didn’t catch these inventory movements. Do you believe that the external auditors were negligent in this case?

Exercise 6-15

**Securities and Exchange Commission**
Many people have argued that the purpose of the SEC is to protect investors. Some believe that the best way to do this is by preventing weak companies from issuing stock. Others say that the SEC should require full disclosure and then let the buyer beware. Which do you think is more appropriate: a preventive role or a disclosure role?

discussion cases

**Case 6-1**

**Auditing a Company**
Jerry Stillwell, the owner of a small company, asked Jones, a CPA, to conduct an audit of the company’s financial statements. Stillwell told Jones that the audit needed to be completed in time to submit audited financial statements to a bank as part of a loan application. Jones immediately accepted the assignment and agreed to provide an auditor’s report within two weeks.

Because Jones was busy, he hired two accounting students to perform the audit. After two hours of instruction, he sent them off to conduct the audit. Jones told the students not to spend time reviewing the internal controls, but instead to concentrate on proving the mathematical accuracy of the ledgers and other financial records.

The students followed Jones’s instructions, and after 10 days, they provided the financial statements, which did not include notes. Jones reviewed the statements and prepared an auditor’s report. The report did not refer to generally accepted accounting principles and contained no mention of any qualifications or disclosures. Briefly describe the problems with this audit.

**Case 6-2**

**Auditing Practice**
A few years ago, the owners of an electronics wholesale company committed massive fraud by overstating revenues on the financial statements. They recorded three large fictitious sales near the end of the year to the retailers SILO, CIRCUIT CITY, and WAL-MART. The three transactions overstated revenues, receivables, and income by nearly $20 million. As part of the audit procedures, the external auditors sent requests for confirmation to the three stores to ensure that they did, in fact, owe the electronics company $20 million. In the meantime, the owners of the electronics company rented mailboxes in the cities where the three “customers” were headquartered, using names very similar to those of the three “customers.” The requests for confirmation were sent to the mailboxes. The owners completed the confirmations and sent them back to the auditors, confirming the $20 million in receivables. With respect to the fraud, answer the following two questions:

1. What journal entries would the fraud perpetrators have entered into the financial records to overstate revenues?
2. Should the external auditors be held liable for not catching the fraud?
### Case 6-3

**Income Smoothing and an IPO**

You are an analyst for an investment fund that invests in initial public offerings (IPOs). You are looking at the financial statements of two companies, Clark Company and Durfee Company, that plan to go public soon. Net income for the past three years for the two companies has been as follows (in thousands):

<table>
<thead>
<tr>
<th>Year</th>
<th>Clark Net Income</th>
<th>Durfee Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$10,000</td>
<td>$17,000</td>
</tr>
<tr>
<td>2006</td>
<td>14,000</td>
<td>1,000</td>
</tr>
<tr>
<td>2007</td>
<td>20,000</td>
<td>26,000</td>
</tr>
</tbody>
</table>

If both companies issue the same number of shares and if the initial share prices are the same, which of the two companies appears to be a more attractive investment? Explain your reasoning. Also, what alternate sources of data would you look at to find out if the reported earnings amounts accurately portray the business performance of these two companies over the past three years?

### Case 6-4

**If It Isn't Fraud, Then It’s Ethical**

Cruella DeVil is the chief financial officer (CFO) of a local publicly-traded company. Cruella was recently invited to speak to accounting students at the local university. One of the students asked Cruella whether she thought earnings management was ethical. Cruella laughed and responded that her view was that anything that was not explicitly prohibited by the accounting standards or by government regulations was ethical. What do you think of Cruella’s opinion?

### Case 6-5

**GAAP Is a Point, Not an Oval!**

You are the chief financial officer (CFO) of Lorien Company, which is publicly traded. At the annual shareholders’ meeting, you have been asked to discuss the company’s recent reported results. As part of your presentation, you illustrated the minimum and maximum values for net income that could have been reported by Lorien using a range of accounting assumptions used by other companies in your industry. Your statement prompted a cry of outrage from one of the shareholders present at the meeting. This shareholder accused you of being an unprincipled liar. This shareholder stated that any suggestion that there is a range of possible net income values for a given company in a given year indicates an overly liberal approach to financial reporting. This shareholder has moved that your employment contract be immediately terminated because of an apparent lack of moral character. The shareholder’s arguments have been persuasive to a large number of people present at the meeting. What can you say to defend yourself?

### Judgment Calls

#### Judgment 6-1

**You Decide: Which is more important—having a good system of internal controls or hiring honest employees?**

Is an internal control structure really necessary? Your uncle doesn’t seem to think so. He works for a regional employment staffing service and recently commented, “As long as a company hires hard-working, honest people, fraud and abusive financial reporting cases will be almost nonexistent. People with integrity will always make the right choice. In the last six months, we
haven’t placed anyone for employment who has been fired or let go for fraudulent activity!” A friend argues, however, that anyone presented with the right pressures can commit fraud and that opportunities must be eliminated through an effective internal control structure. Who do you agree with?

Judgment 6-2

You Decide: Can auditors rely on client personnel to assist them with their audit?

Should external auditors do all audit procedures themselves, or should the relationship between the auditor and the client be more friendly? You have just graduated from college and are now working as an auditor for a public accounting firm. Your first client is a major shipping company on the west coast that specializes in sending goods to China. As part of your first assignment, you are asked to count the number of metal containers in the storage warehouse and also verify their contents. As you begin, the warehouse manager (and long-time friend of the firm) comes to you and says, “Don’t worry about looking inside the containers. Our guys did that last week and we are running low on time.” What should you do?

Competency Enhancement Opportunities

- Analyzing Real Company Information
- International Case
- Ethics Case
- Writing Assignment
- The Debate
- Cumulative Spreadsheet Project
- Internet Search

The following additional assignments provide opportunities for students to develop critical thinking, ethical perspectives, oral and written communication skills, experience with electronic research, and teamwork through group and business activities.

Analyzing Real Company Information

Analyzing 6-1 (Microsoft)

The 2002 Form 10-K for MICROSOFT is included in Appendix A. Locate that Form 10-K and consider the following questions:

1. With respect to the report of the external auditors to “the Board of Directors and Stockholders of Microsoft Corporation”:
   a. Who is Microsoft’s external auditor?
   b. How long after the end of Microsoft’s fiscal year did the external auditor complete the audit?

2. With respect to the report of management concerning the financial statements:
   a. Who is responsible for the financial statements?
   b. After reading the paragraph on internal control, indicate whether you agree or disagree with the following statement: “The purpose of an internal control system is to ensure that all transactions are always recorded and that all assets are always completely safeguarded.”
   c. After looking at the description of the members of the audit committee, do you think that Bill Gates is a member of that committee?
Analyzing 6-2 (Circle K)

At one time, CIRCLE K was the second-largest convenience store chain in the United States (behind 7-ELEVEN). At its peak, Circle K, based in Phoenix, Arizona, operated 4,685 stores in 32 states. Circle K’s rapid expansion was financed through long-term borrowing. Interest on this large debt, combined with increased price competition from convenience stores operated by oil companies, squeezed the profits of Circle K. For the fiscal year ended April 30, 1990, Circle K reported a loss of $773 million. In May 1990, Circle K filed for Chapter 11 bankruptcy protection. Subsequently, Circle K was taken over by TOSCO, a large independent oil company.

1. In the fiscal year ended April 30, 1989, Circle K experienced significant financial difficulty. Reported profits were down 74.5% from the year before. In the president’s letter to the shareholders, Circle K explained that 1989 was a “disappointing” year and that management was seeking some outside company to come in and buy out the Circle K shareholders. How do you think all this bad news was reflected in the auditor’s report accompanying the financial statements dated April 30, 1989?

2. As mentioned, Circle K reported a loss of $773 million for the year ended April 30, 1990. Just a week after the end of the fiscal year, the CEO was fired. One week after that, Circle K declared bankruptcy. The audit report was completed approximately two months later. How do you think the news of the bankruptcy was reflected in the auditor’s report accompanying the financial statements dated April 30, 1990?

International Case

Do the Financial Statements Give a True and Fair View?

SWIRE PACIFIC, LTD., based in Hong Kong, is one of the largest companies in the world. The primary operations of the company are in the region of Hong Kong, China, and Taiwan where it has operated for over 125 years. Swire operates CATHAY PACIFIC AIRWAYS and has extensive real estate holdings in Hong Kong. The 2002 auditor’s report (prepared by PRICEWATERHOUSE-COOPERS) for Swire Pacific, dated March 6, 2003, read as follows (in part):

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the circumstances of the Company and the group consistently applied and adequately disclosed. . . .

In our opinion the accounts give a true and fair view of the state of affairs of the company and of the group as at 31st December 2002. . . .

Although the concept of a “true and fair view” is not part of the auditor’s terminology in the United States, it is used by auditors all over the world and is also discussed as part of International Accounting Standards (IAS). The “true and fair view” concept states that an auditor must make sure that the financial statements give an honest representation of the economic status of the company, even if the company violates generally accepted accounting principles in order to do so.

1. Review the opinion language in the auditor’s report for MICROSOFT (see Appendix A). Does the audit report state unconditionally that Microsoft’s financial statements are a fair representation of the economic status of the company?

2. Auditors in the United States concentrate on performing audits to ensure that financial statements are prepared in accordance with generally accepted accounting principles. What
economic and legal realities in the United States would make it difficult for U.S. auditors to apply the “true and fair view” concept?

▶ Ethics Case

Blowing the Whistle on Former Partners

On St. Patrick’s Day in 1992, CHAMBERS DEVELOPMENT COMPANY, one of the largest landfill and waste management firms in the United States, announced that it had been engaging in improper accounting for years. Wall Street fear (over what this announcement implied about the company’s track record of steady earnings growth) sent Chambers’ stock price plunging by 62% in one day.

The improper accounting by Chambers had been discovered in the course of the external audit. The auditors found that $362 million in expenses had not been reported since Chambers first became a public company in 1985. If this amount of additional expense had been reported, it would have completely wiped out all the profit reported by Chambers since it first went public. The difficult part of this situation was that a large number of the financial staff working for Chambers were former partners in the audit firm performing the audit. These accountants had first worked as independent external auditors at Chambers, then were hired by Chambers, and subsequently were audited by their old partners.

What ethical and economic issues did the auditors of Chambers Development Company face as they considered whether to blow the whistle on their former partners?

▶ Writing Assignment

External Auditors

Visit or call a local CPA firm (or the local office of a multi-office CPA firm). Ask about career opportunities, the size of the firm’s staff, who some of its major clients are, and other facts about the firm. Then, write a one-page summary of your visit.

▶ The Debate

Who Needs Internal Control?

An internal control system is intended to ensure that all transactions are properly approved and recorded, that assets and records are safeguarded, and that operations run efficiently. As with any other system in a business, an internal control system costs money to operate.

Divide your group into two teams.

- One team represents the “Hire Honest and Smart” group. Prepare a two-minute oral presentation supporting the notion that if a company would focus on hiring only honest and smart employees, it would not need to spend money designing and operating an internal control system. Most of the functions of internal control are to prevent employees from stealing and to make it difficult for inept employees to commit costly mistakes.

- The other team represents the “No Trust” group. Prepare a two-minute oral presentation arguing that a company must set up a careful internal control system because, given the right opportunity and motive, any employee can turn into a thief. In addition, a company cannot rely on the good intentions of employees to keep the business running smoothly. Instead, top management must design systems that will keep things running smoothly in spite of the mistakes of employees.
Cumulative Spreadsheet Project

This spreadsheet assignment is a continuation of the spreadsheet assignment given in Chapter 2. If you completed that spreadsheet, you have a head start on this one.

1. Refer back to the financial statement numbers for Handyman Company for 2006 [given in part (1) of the Cumulative Spreadsheet Project assignment in Chapter 2]. Using the balance sheet and income statement created with those numbers, create spreadsheet cell formulas to compute and display values for the following ratios:
   a. Current ratio
   b. Debt ratio
   c. Asset turnover
   d. Return on equity

2. To observe the impact that errors and fraudulent transactions can have on the financial statements, determine what the ratios computed in (1) would have been if (1) each of the following transactions was recorded as described and (2) the transaction was recorded correctly. Treat each transaction independently, meaning that before determining the impact of each new transaction you should reset the financial statement values to their original amounts. Each of the hypothetical transactions is assumed to occur on the last day of the year.
   a. Created receivables by creating fictitious sales of $140 all on account.
   b. Purchased $80 of inventory on account but incorrectly increased the property, plant, and equipment account instead of increasing Inventory.
   c. Borrowed $60 with a short-term payable. The liability was incorrectly recorded as Long-Term Debt.
   d. An inventory purchase on account in the amount of $90 was not recorded until the next year.

Internet Search

MCI (formerly WorldCom)

Access the Web site of MCI at http://www.mci.com. Sometimes Web addresses change, so if this address doesn’t work, access the Web site for this textbook (http://albrecht.swlearning.com) for an updated link.

Once you’ve gained access to the site, answer the following questions:

1. How many individuals does MCI employ around the world, and in how many countries?
2. Who assumed the position of CEO of the company following the accounting scandals that occurred in 2002?
3. Locate the company’s April 14, 2003, press release (look in “press release archives”). At the same time the company announced its name change, it also made another announcement related to a court filing. What was that announcement?
As a recently hired accountant for a small business, SMC, Inc., you are provided with last year’s balance sheet, income statement, and post-closing trial balance to familiarize yourself with the business.

### SMC, Inc.
#### Balance Sheet
**December 31, 2006**

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$34,500</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>25,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>10,000</td>
</tr>
<tr>
<td>Supplies</td>
<td>200</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$69,700</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Stockholders’ Equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$12,000</td>
</tr>
<tr>
<td>Salaries payable</td>
<td>1,000</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>3,675</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>$16,675</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td></td>
</tr>
<tr>
<td>Capital stock (10,000 shares outstanding)</td>
<td>$25,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>28,025</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity</strong></td>
<td>53,025</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders’ equity</strong></td>
<td>$69,700</td>
</tr>
</tbody>
</table>

### SMC, Inc.
#### Income Statement
**For the Year Ended December 31, 2006**

<table>
<thead>
<tr>
<th>Description</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>$110,000</td>
</tr>
<tr>
<td>Rent revenue</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total revenues</strong></td>
<td>$111,000</td>
</tr>
<tr>
<td>Less cost of goods sold</td>
<td>60,000</td>
</tr>
<tr>
<td><strong>Gross margin</strong></td>
<td>$ 51,000</td>
</tr>
<tr>
<td>Less operating expenses:</td>
<td></td>
</tr>
<tr>
<td>Supplies expense</td>
<td>$ 400</td>
</tr>
<tr>
<td>Salaries expense</td>
<td>22,000</td>
</tr>
<tr>
<td>Miscellaneous expense</td>
<td>4,100</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td>26,500</td>
</tr>
<tr>
<td><strong>Income before taxes</strong></td>
<td>$ 24,500</td>
</tr>
<tr>
<td>Less income taxes</td>
<td>3,675</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>$ 20,825</td>
</tr>
<tr>
<td>Earnings per share (20,825 / 10,000 shares)</td>
<td>$2.08</td>
</tr>
</tbody>
</table>
SMC, Inc.
Post-Closing Trial Balance
December 31, 2006

<table>
<thead>
<tr>
<th>Description</th>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$34,500</td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td></td>
<td>$25,000</td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td>$10,000</td>
</tr>
<tr>
<td>Supplies</td>
<td></td>
<td>$200</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td></td>
<td>$12,000</td>
</tr>
<tr>
<td>Salaries Payable</td>
<td></td>
<td>$1,000</td>
</tr>
<tr>
<td>Income Taxes Payable</td>
<td></td>
<td>$3,675</td>
</tr>
<tr>
<td>Capital Stock</td>
<td></td>
<td>$25,000</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td></td>
<td>$28,025</td>
</tr>
<tr>
<td>Totals</td>
<td>$69,700</td>
<td>$69,700</td>
</tr>
</tbody>
</table>

You are also given the following information that summarizes the business activity for the current year, 2007.

a. Issued 5,000 additional shares of capital stock for $10,000 cash.
c. Paid $3,600 cash on November 1 to lease a truck for one year.
d. Received $1,200 on November 1 from a tenant for six months’ rent.
e. Paid $600 on October 1 for a one-year insurance policy.
f. Purchased $500 of supplies for cash.
g. Purchased inventory for $100,000 on account.
h. Sold inventory for $150,000 on account; cost of the merchandise sold was $80,000.
i. Collected $120,000 cash from customers’ accounts receivable.
j. Paid $70,000 cash for inventories purchased during the year.
k. Paid $25,000 for sales reps’ salaries, including $1,000 owed at the beginning of 2007.
l. No dividends were paid during the year.
m. The income taxes payable for the year were paid. Income taxes are based on a 15% corporate tax rate.
n. For adjusting entries, all prepaid expenses are initially recorded as assets, and all unearned revenues are initially recorded as liabilities.
o. At year-end, $150 worth of supplies are on hand.
p. At year-end, an additional $5,000 of sales salaries are owed, but have not yet been paid.

You are asked to do the following:

1. Journalize the transactions for the current year, 2007, using the accounts listed on the financial statements and other appropriate accounts (you may omit explanations).
2. Set up T-accounts and enter the beginning balances from the December 31, 2006, post-closing trial balance for SMC. Post all current year journal entries to the T-accounts.
3. Journalize and post any necessary adjusting entries at the end of 2007. *(Hint: Items b, c, d, e, m, o, and p require adjustment.)*
4. After the adjusting entries are posted, prepare a trial balance, a balance sheet, and an income statement for 2007. *(Hint: Income before income taxes should equal $39,600.)*
7. **Interpretive Question:** What is your overall assessment of the financial health of SMC, Inc.?