Chapter 6

Why Should Decision Makers Trust Financial Statements?

Video Clip

(click to see video)

In this video, Professor Joe Hoyle introduces the essential points covered in Chapter 6 "Why Should Decision Makers Trust Financial Statements?".

6.1 The Need for the Securities and Exchange Commission

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Understand the reasons that reported financial statements might not be presented fairly.
2. Describe the mission of the Securities and Exchange Commission (SEC).
3. Explain the purpose of the EDGAR (Electronic Data Gathering and Retrieval) system.
4. Discuss the times when state laws apply to corporate securities rather than the rules and regulations of the SEC.
5. Explain the relationship of the SEC and the Financial Accounting Standards Board (FASB).

Financial Reporting and the Need for Trust

Question: The importance of financial statements to any person who is analyzing a business or other organization appears rather obvious. The wide range of information provides a portrait of the reporting entity that reflects both its financial health and potential for future success. However, a degree of skepticism seems only natural when studying such statements because they are prepared by the company's own management, hardly an impartial group.

Decision makers are not naïve. They must harbor some concern about the validity of figures and other data that are self-reported. Company officials operate under pressure to present positive financial results consistently, period after period. What prevents less scrupulous members of management from producing fictitious numbers just to appear especially profitable and financially strong? Why should any investor or creditor be willing to risk money based on financial statements that the reporting organization itself has prepared?

Answer: The possible presence of material misstatements (created either accidentally or on purpose) is a fundamental concern that should occur to every individual who studies a set of financial statements. Throughout history, too many instances have arisen where information prepared by management ultimately proved to be fraudulent causing decision makers to lose fortunes. In fact, the colorful term "cooking the books" reflects the very real possibility of that practice. **Enron**, **WorldCom**, and **Madoff Investment Securities** are just a few examples of such scandals.

Although often viewed as a relatively recent linguistic creation, variations of the term "cooking the books" had already been in use for over one hundred years when Tobias Smollett included the following phrase in his book *The Adventures of Peregrine Pickle*, first published in 1751: "Some falsified printed accounts, artfully cooked up, on purpose to mislead and deceive." Even over 260 years later, those words aptly describe accounting fraud.

The potential for creating misleading financial statements that eventually cause damage to both investors and creditors is not limited to a particular time or place. Greed and human weakness have always rendered the likelihood of a perfect reporting environment virtually impossible. In addition, fraud is never the only cause for concern. Often a company's management is simply overly (or occasionally irrationally) optimistic about future possibilities. That is human nature. Therefore, financial information should never be accepted blindly, especially if monetary risk is involved.

Over the decades, numerous laws have been passed in hopes of creating a system to ensure that all distributed financial statements fairly present the underlying organization they profess to report. Because of the need for economic stability, this is an objective that governments take seriously. Under capitalism, the financial health of the entire economy depends on the ability of worthy businesses to gain external financing for both operations and expansion. Without trust in the reporting process, people simply will not invest so that the raising of large monetary amounts becomes difficult, if not impossible. As has been seen in recent times, hesitancy on the part of investors and creditors restricts the growth of businesses and undermines the strength of the entire economy.

In the United States, ultimate responsibility for the availability of complete and reliable information about every organization that issues publicly traded securitiesFor this introductory textbook, a security will include ownership shares of a company as well as debt instruments such as bonds that can be sold from one party to another. A debt instrument is a promise to pay a stated amount plus a specified rate of interest at a particular point in time. lies with the **Securities and Exchange Commission (SEC)**[1]. The SEC is an independent agency within the federal government established by the Securities Exchange Act of 1934. Its mission, as

1. Federal government agency holding legal responsibility over the reporting made by companies that issue publicly traded securities in the United States; works to ensure that this entire reporting process functions as intended by the government; has opted to leave development of authoritative accounting principles to FASB, although a change to IFRS produced by the IASB may be required in the future.

stated at its Web site (http://www.sec.gov), “is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”

Virtually all U.S. companies of any significant size—as well as many foreign companies—fall under the jurisdiction of the SEC because their securities (either ownership shares or debt instruments such as bonds) are traded publicly within the United States. Financial statements and numerous other formal filings have to be submitted regularly to the SEC by these companies. A Form 10-K, which includes financial statements as well as a substantial amount of additional data, must be submitted each year. A Form 10-Q serves the same purpose each quarter. This information is then made available to the public through a system known as **EDGAR (Electronic Data Gathering and Retrieval)**[2].Considerable information on accessing the financial data filed with the SEC can be found at http://www.sec.gov/edgar.shtml. Any student considering a career in financial analysis or the like should visit this site to become familiar with its contents, especially the tutorial, so that the EDGAR system can be used to gain information provided by publicly traded companies. All such statements and other released data must conform precisely to the extensive rules and regulations of the SEC.

Companies that do not issue even a minimum amount of securities to the public normally are required to comply with state laws rather than with the SEC and federal laws. Financial statements for such companies, although not as likely to be public information, are often required by financial institutions and other interested parties. For example, a bank might insist that a local convenience store include financial statements as part of a loan application. The form and distribution of that financial information must conform to state laws (often referred to as “blue sky laws”).

The Relationship of the SEC to Official Accounting Standards

Question: Companies such as General Electric or Starbucks that issue securities to the public are required to satisfy all applicable federal laws and regulations. The SEC has authority over the amount and nature of the information that must be provided and the actions that can be taken by both the buyer and the seller of the securities. Does the SEC develop the specific accounting principles to be followed in the production of financial statements that are issued by public companies?

2. SEC reporting system requiring companies to file their financial statements and other information electronically to allow current and potential investors access quickly and easily over the Internet.

Answer: Legally, the SEC has the ability to establish accounting rules for all companies under its jurisdiction simply by specifying that certain information must be presented in a particular manner in the public filings that it requires. However, for decades the SEC has opted to leave the development of authoritative accounting principles to the Financial Accounting Standards Board (FASB). As discussed in an earlier chapter, for nearly 40 years FASB has had the primary authority for producing U.S. GAAP. Because FASB is a private (rather than government) organization, this decision has, at times, been controversial. Some view it as an abdication of an important responsibility by the federal government so that the public is at risk. The assumption by the SEC is that the members of FASB can be trusted to study each reporting issue meticulously before arriving at a reasoned resolution.

The SEC does allow certain companies to follow International Financial Reporting Standards (IFRS) so that, in those cases, the same reliance is being placed on the work of the International Accounting Standards Board (IASB) in London. As indicated previously, movement to a single set of global standards over the next few years is constantly under debate. One of the arguments about the possible move by the SEC from U.S. GAAP to IFRS is whether the IASB as it is currently structured can be trusted as much in the future as FASB has been in the past.

At present, FASB produces accounting rules to be applied by all for-profit and not-for-profit organizations in the United States, while state and local governments follow accounting standards produced by a sister organization, the **Governmental Accounting Standards Board (GASB)**[3]. In July, 2009, *FASB Accounting Standards Codification* was released to serve as the single source of authoritative nongovernmental U.S. GAAP. As a result, all the previous individual rules that had been created over several decades were reclassified into a logical framework. According to a FASB news release, "The Codification reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics and displays all topics using a consistent structure. It also includes relevant Securities and Exchange Commission (SEC) guidance that follows the same topical structure in separate sections in the Codification."News release by FASB, July 1, 2009.

Groups other than FASB also contribute to accounting standards but in a much less significant fashion. The most important of these is the **Emerging Issues Task Force (EITF)**[4], which was created in 1984 to assist FASB.In Chapter 2 "What Should Decision Makers Know in Order to Make Good Decisions about an Organization?", http://www.fasb.org was mentioned as an excellent source of information about FASB. One of the tabs available at this Web site discusses the role of the EITF. The EITF examines new problems when they initially arise in hopes of coming to quick agreement as to an appropriate method of reporting based on existing U.S. GAAP. Thus, the EITF is not forming U.S. GAAP as much as helping to apply it to newly emerging situations. If consensus is achieved (that is, no more than three members object), the conclusions rendered by the EITF are considered to be authoritative until such time—if ever—as FASB provides its own formal guidance. In this way,

3. Nonprofit organization that holds the authority for establishing accounting standards for state and local government units in the United States; sister organization to FASB.

4. A group formed to assist FASB by examining new accounting issues as they arise in hopes of arriving at quick agreement as to the appropriate method of reporting based on existing U.S. GAAP.

FASB does not have to issue hasty pronouncements to resolve every unique reporting concern when it first appears.

The SEC itself is not totally absent from the formation of U.S. GAAP. It occasionally issues guidelines to ensure that adequate information is being disclosed to the public through its own rules and interpretive releases. That is especially true in situations where reporting concerns have emerged and adequate official guidance does not exist. The SEC tends to restrict its own power over financial reporting to those areas where U.S. GAAP—for whatever reason—has not yet been well constructed. Assume, for example, that a new type of transaction arises and the EITF is unable to arrive at a consensus resolution. The SEC might specify relevant data to be included in the notes to financial statements to better describe these events or could prohibit certain methods of reporting until FASB has the opportunity to provide a studied ruling.

TEST YOURSELF

Question:

The Barone Company is currently dealing with a unique set of transactions that took place recently. The company accountant has studied the appropriate accounting rules in preparing the information to be included in Barone's financial statements. These statements are being issued because the company's stock is publicly traded on a stock exchange. What is the most likely source of the accounting rules followed by the accountant?

a. The Securities and Exchange Commission (SEC)
b. The Financial Accounting Standards Board (FASB)
c. The Governmental Accounting Standards Board (GASB)
d. The Emerging Issues Task Force (EITF)

Answer:

The correct answer is choice b: The Financial Accounting Standards Board (FASB).

Explanation:

U.S. GAAP is produced primarily by FASB. The SEC has ultimate legal authority over the financial reporting of companies that issue securities to the public. However, the actual setting of accounting standards for businesses and other nongovernmental organizations has been left to FASB. The EITF only seeks to apply existing rules to new situations. GASB produces authoritative accounting standards, but only for the financial reporting of states, cities, and other nonfederal governmental units.

KEY TAKEAWAY

The U.S. economy depends on the willingness of investors and creditors to risk conveying their hard-earned financial resources to businesses and other organizations for operating and growth purposes. Financial statements play an essential role in this process by providing information that allows such decisions to be made based on proper analysis. However, accounting scandals periodically remind all parties that fraud can occur in the financial reporting process. In the United States, the Securities and Exchange Commission (SEC) is responsible for the fair distribution of information by those companies that issue publicly traded securities such as capital stock and debt instruments (such as bonds). The EDGAR system makes this information readily available to all interested parties. State laws apply to all other organizations. In hopes of creating a well-developed system of considered accounting principles, the SEC has chosen to allow FASB to set U.S. GAAP, although a movement to IFRS in the future is certainly possible. The SEC typically restricts its direct involvement in accounting to the creation of rules that specify required disclosure of information, but only in situations where current standards are found to be unclear or incomplete.

6.2 The Role of the Independent Auditor in Financial Reporting

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Understand the purpose of an independent audit.
2. List the two primary components of an independent audit.
3. Explain the function of an independent audit firm.
4. Describe the steps required to become a Certified Public Accountant (CPA).
5. List the various types of services provided by many public accounting firms.
6. Discuss the necessity for the creation of the Public Company Accounting Oversight Board (PCAOB) and describe its function.

The Need for an Independent Audit of Financial Statements

Question: The SEC allows FASB to set U.S. GAAP. Does the SEC physically visit each company that issues securities to the public to ensure that periodic financial statements properly follow the rules and guidelines of U.S. GAAP?

Answer: A detailed examination of the financial statements produced by thousands of publicly traded companies around the world would require a massive work force with an enormous cost. Therefore, this essential role in the financial reporting process has been left by the SEC to auditing (also known as public accounting) firms that operate both inside and outside the United States. Before submitting statements to the SEC and then to the public, reporting companies such as **IBM** and **Wells Fargo** must hire an independent auditing firm to do the following:

- Perform an **audit**[5] (examination) of the company's financial statements
- Provide a report stating whether sufficient supporting evidence was obtained to enable the auditor to provide reasonable assurance that the statements are presented fairly because they contain no material misstatements according to U.S. GAAP

5. An examination carried out by an independent CPA of the evidence underlying the information presented in a set of financial statements followed by the issuance of a report as to whether the statements contain material misstatements in accordance with U.S. GAAP; this opinion is intended to provide reasonable assuranace that the statements are fairly presented, which adds credibility to the information provided.

The independent auditor's written report is then attached to the financial statements for all to read. This expert opinion is essential to the integrity of the reporting process because it tells decision makers whether they should feel safe relying on the financial information. Even many companies that are not affected by the rules of the SEC have their statements audited by an independent firm to enhance credibility. For example, a convenience store seeking a bank loan could pay for an audit in hopes of increasing the chances that the application will be approved (or because bank officials have required the audit for the bank's own protection).

Not surprisingly, companies that have independent audits performed on their financial statements are able to get loans at lower interest rates than comparable organizations that do not have such examinations.David W. Blackwell, Thomas R. Noland, and Drew B. Winters, "The Value of Auditor Assurance: Evidence from Loan Pricing," *Journal of Accounting Research*, Spring 1998, 57–70. The audit and the related audit report serve to reduce the lender's risk of loss. Thus, banks and other institutions require a lower rate of interest to compensate for their risk of default.

In the United States, **independent auditing firms**[6] can only be operated by individuals who have been formally recognized by a state government as **Certified Public Accountants (CPAs)**[7].The rules for becoming a CPA vary by state but usually include a specific amount and level of education as well as a passing grade of at least 75 or above on the four parts of the uniform CPA Exam. Some states also require a defined length of practical experience such as one or two years. Considerable information about the auditing profession and the possibility of becoming a CPA can be found at http://www.thiswaytocpa.com. Such firms range in size from massive (**KPMG** employs 137,000 individuals working in 144 countries and generated revenues of approximately $20.6 billion for the year ended September 30, 2010See http://www.kpmg.com as of August 12, 2011.) to organizations comprised of only one or two people.

Obviously, for the financial statements of the biggest organizations (the **ExxonMobils** and **Walmarts** of the world), only a public accounting firm of truly significant size could effectively perform an audit engagement. Consequently, four firms (known collectively as the **Big Four**[8]) have become huge global organizations:

- **Deloitte Touche Tohmatsu**
- **Ernst & Young**
- **KPMG**
- **PricewaterhouseCoopers**

6. Organizations operated by individuals recognized by a state government as Certified Public Accountants (CPAs) to provide independent auditing and other accounting services to the public; also known as CPA firms or public accounting firms.
7. Individuals who have met state requirements of education, practical experience, and passing the Uniform CPA Examination; the CPA designation is a license that allows a person to provide auditing and other accounting services to the public and serves as a symbol of technical expertise.
8. Term used to encompass the four largest CPA firms operating internationally: **Deloitte Touche Tohmatsu**, **Ernst & Young**, **KPMG**, and **PricewaterhouseCoopers**; these four firms perform independent audits on most of the world's largest companies.

However, thousands of smaller independent CPA firms exist providing numerous services, such as audit, **tax planning and preparation**[9], and **advisory work**[10] for a wide range of clients. **Ernst & Young** indicates on its Web site (http://www.ey.com) that the following services are provided to its clients with each explained in detail: advisory, assurance, tax, transactions, strategic growth markets, and specialty services.

TEST YOURSELF

Question:

Financial statements have been produced by the management of the Southern Central Corporation. Unfortunately, a significant expense was accidentally recorded as an asset, so the company's net income was overstated by a large amount. Who is most likely to discover this mistake?

a. The board of directors for the company
b. Employees of the Securities and Exchange Commission
c. The company's independent CPA audit firm
d. Major investors in the company's stock

Answer:

The correct answer is choice c: The company's independent CPA audit firm.

Explanation:

The purpose of a financial statement audit performed by an independent CPA firm is to provide reasonable assurance that information is presented fairly according to U.S. Generally Accepted Accounting Principles because no material misstatements are present. While accumulating evidence to support this assertion, the independent auditor should discover that the expense has been improperly capitalized as an asset. Various testing techniques are designed to bring problems such as this to light.

Standards for a Proper Audit

Question: FASB creates U.S. GAAP, the official standards for the preparation of financial statements. What group sets the examination and reporting rules to be followed by independent auditors?

9. One of the professional services performed by many CPA firms, including the preparation of tax returns and the creation of tax strategies to help minimize tax payments.

10. One of the professional services performed by many CPA firms to assist businesses in operating more effectively and efficiently, and, therefore, more profitably.

The work performed by auditors is not in accordance with accounting principles. Instead, these experts are seeking to determine whether U.S. GAAP was applied properly when financial statements were created. Auditing firms provide a vital service by adding credibility to that reported information. How do independent auditors know what actions should be taken in assessing the data disclosed by a company such as Xerox or Bank of America?

Answer: When an audit is performed on the financial statements of any organization that issues securities to the U.S. public, the examination and subsequent reporting is regulated by the **Public Company Accounting Oversight Board (PCAOB)**[11]. The PCAOB was brought into existence by the U.S. Congress through the **Sarbanes-Oxley Act of 2002**[12], legislation passed in response to a number of massive accounting scandals, including **Enron** and **WorldCom**. Members of Congress apparently felt that the auditing profession had failed to provide adequate protection for decision makers who were relying on published financial information. Consequently, the federal government became more involved.

The PCAOB was established under the oversight and enforcement authority of the SEC. It holds wide-ranging powers that include the creation of official guidelines for the performance of a proper audit. Its vision is stated as follows: "Using innovative and cost-effective tools, the PCAOB aims to improve audit quality, reduce the risks of auditing failures in the U.S. public securities market, and promote public trust in both the financial reporting process and auditing profession."See http://www.pcaob.org.

If an audit is performed on financial statements that are produced by an organization that does not issue securities to the public, the PCAOB holds no authority. For such smaller engagements, the **Auditing Standards Board (ASB)**[13] officially sets the rules for an appropriate audit. The ASB is a technical committee within the **American Institute of Certified Public Accountants (AICPA)**[14], a national professional organization of CPAs.

A local convenience store, a medical practice, or a law firm (for example) might choose to have an audit on its financial statements. These audits fall under the guidelines provided by the ASB rather than the PCAOB because the organizations do not issue securities that are publicly traded. Thus, the rules for performing an audit on a large company can differ somewhat from those applied to a smaller private one.

11. Private sector, nonprofit corporation brought into existence by the U.S. Congress through the Sarbanes-Oxley Act of 2002 to oversee the audits of public companies in hopes of protecting and better serving investors.
12. Federal securities law passed by the U.S. Congress in response to the **Enron**, **WorldCom**, and other major accounting scandals; it brought about many changes in the audit process and in the relationship between reporting companies and their independent auditors.
13. Technical body within the AICPA that holds the authority to set the rules for appropriate audits of organizations that do not issue securities to the public (often referred to as privately held organizations).
14. A national professional organization of CPAs that sets ethical requirements, conducts research, and helps set a high standard for the profession.

The Role of the SEC

Question: FASB sets U.S. GAAP. The PCAOB (and the ASB) establishes rules for performing an audit. ***What function does the SEC actually serve?***

Answer: The goal of the work done by the SEC is summed up in the following statement from its Web site: "The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it."See http://www.sec.gov.

Thus, the SEC strives to make certain that the organizations that fall under its jurisdiction are in total compliance with all laws so that decision makers have ready access to information that is viewed as relevant. It reviews the required filings submitted by each organization to ensure that the rules and regulations are followed. The SEC also has the power to enforce securities laws and punish companies and individuals who break them. For example, if a company fails to disclose a significant transaction or other event that the SEC believes is necessary, all trading of that company's securities can be halted until the matter is resolved. Such regulatory actions can cause a huge financial loss for a business. Thus, compliance is viewed as vital.

In addition, if corporate officials provide false or misleading data, fines and jail time are also possible: "L. Dennis Kozlowski, the former CEO of Tyco International, acquired hundreds of companies between 1996 and 2002 and created a conglomerate that made everything from fire suppression systems to health-care products, with worldwide sales of $40 billion. Now, while serving up to 25 years in jail for misleading investors and stealing money from Tyco, he's watching the breakup of all he built."John Kostrzewa, "After the Scandal, a New Tyco," *The Providence Journal*, July 15, 2007, F-1.

TEST YOURSELF

Question:

Fairchild Corporation is a large retail organization that sells its stock on the New York Stock Exchange. Littleton Corporation is a small retail organization that is privately owned by three investors and raises money through bank loans. Both companies produce financial statements that are audited by independent CPAs. Unfortunately, each set of financial statements contains a material misstatement because, in both cases, a relatively large liability was never recorded. Which of the following statements is true?

a. The rules of the SEC apply to both of these companies.
b. The rules of the PCAOB apply to both auditing firms in connection with these independent audits.
c. The rules of FASB apply to both of these companies.
d. The misstatement is more of a concern in connection with the audit of the publicly owned company.

Answer:

The correct answer is choice c: The rules of FASB apply to both of these companies.

Explanation:

Rules established by the SEC and the PCAOB are directed toward organizations (and their auditors) with publicly traded securities. State laws and the rules of the ASB are applicable to other entities. Misstatements are always a problem in financial statements because individuals rely on those statements in making decisions. However, in almost all cases, accounting rules developed by FASB apply to privately owned companies as well as those that are publicly held.

KEY TAKEAWAY

Independent auditing firms provide credibility to financial statements by examining the evidence that underlies the information provided and then reporting on those findings. Official oversight of the rules for this process is in the hands of the Public Company Accounting Oversight Board (PCAOB) if the audited company issues securities to the public and the Auditing Standards Board (ASB) if not. The role of the Securities and Exchange Commission (SEC) is to ensure that this reporting process is working as intended by the government. The SEC examines the filings of the various companies and can take disciplinarian action if either the company or its officials fail to act appropriately.

6.3 Performing an Audit

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Describe the goal of an auditor in examining an account balance.
2. List the tests that might be performed in auditing a reported balance such as account receivable.
3. Understand the reason that an independent auditor only provides reasonable assurance and not absolute or perfect assurance.

Auditing a Reported Balance

Question: A company creates a set of financial statements for the most recent year. It hires an independent firm of CPAs to audit those statements and prepare a report that will be attached to them. Perhaps this action is required of the company by the SEC or maybe by a local bank or other lender. What work does an independent auditor perform in examining a set of financial statements? The audit firm hopes to be able to provide reasonable assurance to decision makers that these statements are presented fairly and, thus, contain no material misstatements according to U.S. GAAP. How is the auditor able to gain sufficient evidence to make that assertion?

Answer: An independent audit is a complicated activity that often requires scores of experienced CPAs many months to complete. Serious knowledge of the audit process is best achieved by taking upper-level college courses as well as through years of practical experience. However, a general understanding of the process is important because of its relevance to almost all businesses as well as investors and creditors. For that reason, coverage here will include a limited overview of a financial audit.

The numbers found on a set of financial statements do not appear by magic. For example, if receivables are disclosed on a balance sheet as $12.7 million, a legitimate reason has to exist for reporting that particular figure. In preparing statements, company accountants should document the steps taken to arrive at each balance and the work performed to determine the appropriate method of reporting according to U.S. GAAP. The statements are the representation of the company; thus, the burden of proof is on that organization and its officials. The independent auditors then examine the available evidence to ascertain whether reliance on the reported information should be advised.

As an illustration, assume that a business presents a list of 1,000 customers and claims that the total amount due from them is $12.7 million. This figure is reported as "accounts receivable" under the asset section of the year-end balance sheet. The independent audit firm seeks to accumulate sufficient, competent evidence to substantiate that this reported balance is not materially misstated in accordance with U.S. GAAP.

For these receivables, the auditor carries out a number of possible testing procedures to gain the assurance needed. Such techniques might include the following:

- Add the individual account balances to ensure that the total really is $12.7 million.
- Examine sales documents for a sample of individual customers to determine that the amounts sold to them are equal to the figures listed within the receivable. For example, if the sales document indicates that Mr. A bought goods at a price of $1,544, is that same amount found in the company's receivable balance?
- Examine cash receipts documents for a sample of individual customers to ensure that no unrecorded payments were collected prior to the end of the year. If Mr. A paid cash of $1,544 on December 30, was the corresponding receivable balance reduced by that amount prior to the end of the year?
- Contact a sample of the customers directly to confirm that the balance shown is, indeed, appropriate. "Mr. A: Company records show that you owe $1,544 as of December 31. Is that amount correct?"

Through these and other testing procedures, the auditor hopes to ascertain that $12.7 million is a fairly presented amount for this asset. All other reported balances are also examined in a similar manner during the independent audit. The actual quantity and type of testing varies considerably based on the nature of the account. Auditing $12.7 million in receivables requires different steps than investigating a building bought for that same amount. Not surprisingly, large monetary balances often require especially extensive testing. In addition, certain accounts (such as cash or inventory) where the risk of misstatement is particularly high will draw particular attention from the independent auditors.

If the auditor eventually concludes that sufficient evidence has been obtained to reduce the risk of a material misstatement in the financial statements to an acceptably low level, an audit report can be issued with that opinion. Assuming no problems were encountered, reasonable assurance is provided by the independent auditor that the statements are presented fairly and, thus, contain no material misstatements according to U.S. GAAP.

As mentioned, the independent auditor's report is then attached to the financial statements. Upon reading this opinion, investors and creditors should feel confident relying on the information provided by those statements to make their financial decisions about the reporting organization.

TEST YOURSELF

Question:

The Aberton Corporation has recently produced financial statements for Year One. The CPA firm of Nash and Hill has been hired by the company to perform an independent audit. The firm is concerned because the accounts receivable balance seems unreasonably high and might contain a material misstatement. Members of the audit team are least likely to watch for which of the following?

a. The accounts receivable contain fake account balances.
b. The company has failed to record cash amounts collected on its accounts receivable near the end of the year.
c. Credit sales made in Year Two were erroneously recorded in Year One.
d. A large collection received on January 2, Year Two, was recorded on December 30, Year One.

Answer:

The correct answer is choice d: A large collection received on January 2, Year Two, was recorded on December 30, Year One.

Explanation:

The auditor suspects that the accounts receivable balance is inflated. Fake accounts cause that problem and might be fraudulently created to increase reported assets and revenues. Failure to record cash collections also inflates the receivable total because reductions were omitted. Adding Year Two sales into Year One causes the figures for the first period to be overstated. However, recording a cash collection in advance reduces the receivable balance prematurely so that it is understated.

Reasonable Assurance and not Perfect Assurance

Question: One aspect of the audit process seems particularly puzzling. The independent auditor merely provides reasonable assurance. The risk that a material misstatement is included in the accompanying financial statements is only reduced to a low level and not to zero. Why do decision makers who may be risking significant amounts of money not insist on absolute and complete assurance? Because of the potential for financial loss, investors and creditors surely want every possibility of incorrect reporting to be eliminated by the work of *the independent auditor. Is reasonable assurance that no material misstatements are present truly adequate for decision makers who must rely on a set of financial statements for information?*

Answer: As has been stated, independent auditors provide reasonable assurance but not absolute assurance that financial statements are presented fairly because they contain no material misstatements according to U.S. GAAP. A number of practical reasons exist as to why the level of assurance is limited in this manner.

First, many of the figures found on any set of financial statements are no more than estimations. Auditors do not possess reliable crystal balls that allow them to predict the future. The uncertainty inherent in these estimations immediately eliminates the possibility for absolute assurance. For example, reporting the amount of cash that will be collected from a large group of accounts receivable is simply a carefully considered guess. It is presented according to the rules of U.S. GAAP, but it is still an estimate. No one can provide absolute assurance about any estimation.

Second, organizations often take part in so many transactions during a period (millions for many large companies) that uncovering every potential problem or issue during an audit is impossible. Usually, in analyzing most account balances, the independent auditor only has time to test a sample of the entries and adjustments. Without examining every individual event, absolute assurance is not possible. Even with extreme vigilance, material misstatements can always be missed if less than 100 percent of the transactions are tested.

Third, an independent auditor visits a company for a few weeks or months each year to carry out testing procedures. Company officials who want to hide financial problems are sometimes successful at concealment. Auditors can never be completely certain that they have not been victimized by an elaborate camouflage scheme perpetrated by management. Thus, they are not comfortable providing absolute assurance.

Fourth, informed decision makers should understand that independent auditors can only provide reasonable assurance. Through appropriate testing procedures, risk of a material misstatement is reduced to an acceptably low level but not eliminated entirely for the reasons that have been named. Investors and creditors need to take that limitation into consideration when assessing the financial health and future well being of an organization as presented through a set of financial statements. Although the risk is small, their decisions should factor in the level of uncertainty that is always present.

TEST YOURSELF

Question:

The Osgood Company released its Year One financial statements after an audit by the independent audit firm of Hatley, Joyner, and Bostick. Subsequently, a material misstatement was found in these financial statements. If a proper audit was conducted, which of the following is least likely?

a. A large transaction took place early in Year Two but was reported by the company in Year One.
b. A large estimation was made in Year One that eventually proved to be materially incorrect.
c. A large liability was hidden by the management of the company.
d. The company eventually lost a large lawsuit that it had expected to win.

Answer:

The correct answer is choice a: A large transaction took place early in Year Two but was reported by the company in Year One.

Explanation:

Answers b and d relate to estimates. Auditors seek evidence that each estimate is reasonable, but absolute accuracy is impossible. In a proper audit, estimates can prove materially wrong. Answer c relates to the possibility that management can conceal events from the auditors. Auditors work to make sure they are not fooled, but again, absolute assurance is not possible. Answer a is correct; auditors should examine large transactions to determine proper reporting so that the timing error is found.

KEY TAKEAWAY

Financial statements are the product of company management. Independent auditors then seek to obtain sufficient evidence that these statements are presented fairly because no material misstatements are present according to U.S. GAAP. The auditing firm performs extensive testing of the balances and disclosures that are reported. When the risk of a material misstatement has been reduced to an acceptably low level, reasonable assurance can be provided. Thus, decision makers should feel safe using the information. Absolute assurance is not humanly possible because all statements contain numerous estimations and the auditors do not have time (or the need) to examine each individual transaction. Management can, in some cases, also conceal problems from the auditors. Thus, when examining a set of financial statements, decision makers need to understand that only reasonable assurance of no material misstatements is possible and take that into consideration.

6.4 The Need for Internal Control

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Define internal control.
2. Explain a company's need for internal control policies and procedures.
3. Describe the effect that a company's internal control has on the work of the independent auditor.

Internal Controls Within an Organization

Question: In the previous discussions, the role of the independent auditor was described as the addition of credibility to financial statements. All reported figures, though, are still the responsibility of management. How can a company and its officials make certain that the information displayed in a set of financial statements is fairly presented?

Businesses like Barnes & Noble and RadioShack participate in millions of transactions each year in geographically distant store locations as well as through their Web sites. Working with that enormous amount of data, gathered from around the world, must be a daunting technological challenge. Some organizations are able to accumulate and organize such massive quantities of information with few—if any—problems; others seem to be overwhelmed by the task. How do companies ensure that their own information is free of material misstatements?

Answer: The human body is made up of numerous systems that perform specific tasks, such as breathing air, circulating blood, and digesting food. Each system serves its own particular purpose that contributes to the good of the body as a whole. Organizations operate in much the same manner. Numerous systems are designed and set in place by management to carry out essential functions, such as paying employees, collecting cash from customers, managing inventory levels, and monitoring receivable balances. Within each system, individuals are charged with performing specific tasks, often in a preordained sequence. For example, a cash payment received in the mail from a customer should be handled in a set way every time that it occurs to ensure that the money is properly recorded and protected from theft.

To be efficient and effective, these systems must be carefully designed and maintained. They need to keep company assets secure and do so at a minimum cost. In addition, appropriate record keeping is a required aspect of virtually every system. For example, if the payroll system is designed properly, employees are paid when their salaries come due, and adequate documentation is maintained of the amounts distributed. The entire function is performed according to guidelines carefully established by company officials.

Well-designed systems generate information with fewer errors, which reduces the threat of material misstatements. However, simply having systems in place—even if they are properly designed and constructed—is not sufficient to guarantee both the effectiveness of the required actions and the reliability of the collected data.

Thus, extra procedures should be built into each system by management to help ensure that every operation is performed as intended and the resulting financial information is reliable. All the redundancies added to a system to make certain that it functions properly are known collectively as **internal control**[15]. For example, a rule requiring two designated employees to sign any check for over $5,000 (or some other predetermined amount) is part of a company's internal control. There is no inherent necessity for having a second signature; it is an added safeguard included solely to minimize the chance of theft or error. All actions like this comprise a company's internal control.

Internal control policies and procedures can be found throughout the various systems of every company.

- One employee counts cash and a second verifies the figure.
- One employee requests the purchase of an asset and a second authorizes the request.

Internal control is made up of all the added procedures that are performed so that each system operates as intended. Systems cannot be considered well designed without the inclusion of adequate internal control. Management is responsible for the development of effective systems but also for all internal control rules and requirements created to ensure that these systems accomplish their stated objectives.

15. A group of policies and procedures within the accounting and other systems of a company to provide reasonable assurance that they are operating efficiently and effectively as intended by management.

Internal Control and the Independent Auditor

Question: If a company creates and maintains good operating systems with appropriate internal control, the financial information that is produced is less likely to contain material misstatements. In performing an audit, is the work of the independent CPA affected by the company's internal control? Does the quality of internal control policies and procedures impact the amount and type of audit testing that is performed?

Answer: As one of the preliminary steps in an audit examination, the CPA gains an understanding of the internal control procedures included within each of these systems that relates to reported financial accounts and balances.Some internal controls have nothing to do with a company's financial statement accounts and are not of importance to the work of the independent auditor. For example, a company might establish a review procedure to ensure that only deserving employees receive promotions. This guideline is an important internal control for the operating effectiveness of the company. However, it does not relate to a reported account balance and is not evaluated by the independent auditor. The auditor then makes an evaluation of the effectiveness of those policies and procedures. In cases where internal control is both well designed and appears to be functioning as intended, a reduction is possible in the amount of audit testing that is needed. There is less risk involved; the likelihood of a material misstatement is reduced by the company's own internal control.

To illustrate, assume that a company claims to hold accounts receivable totaling $12.7 million. The auditor plans to confirm 100 of the individual balances directly with the customers to substantiate the separate amounts listed in the accounting records. A letter will be written and mailed to each of these individuals asking whether the specified balance is correct. A stamped return envelope is included for the response.

This confirmation process is quite common in auditing financial statements. However, although effective, it is slow and expensive. During the year, assume that the reporting company consistently applied several internal control procedures within those systems that maintain the receivables balances. These controls are evaluated by the independent CPA and judged to be excellent. As a result of this assessment, the auditor might opt to confirm only 30 or 40 individual accounts rather than the 100 that had originally been planned. Because of the quality of internal control in the receivable area, the risk of a material misstatement is already low. Less audit testing is necessary. Both time and money are saved.

Thus, at the beginning of an independent audit, the design of the reporting company's internal control and the effectiveness of its procedures are assessed. Only then does the auditor determine the amount of evidence needed to substantiate that each account balance is presented fairly because no material misstatements are included according to U.S. GAAP.

TEST YOURSELF

Question:

Tomlinson and Partners is a local CPA firm that is in the process of auditing the financial statements of Agnew Corporation. Agnew reports both inventory and accounts receivable, and these accounts have approximately the same monetary balances. However, in doing the audit, the independent CPAs spent over twice as much time in testing inventory. Which of the following is the most likely reason for this allocation of effort?

a. Internal policies for handling accounts receivable are poorly designed.
b. The individuals within the company who monitor accounts receivable do not appear to follow appropriate guidelines.
c. Procedures have been established by management for monitoring the company's inventory, but they appear to be flawed.
d. Employees who maintain the inventory being held by the company are well trained.

Answer:

The correct answer is choice c: Procedures have been established by management for monitoring the company's inventory, but they appear to be flawed.

Explanation:

Here the auditors do more testing of inventory than accounts receivable. Several possible reasons exist. Internal control for inventory might be weaker than that for receivables. Thus, material misstatements are more likely present in inventory. To compensate, added audit testing is needed. In a and b, internal control is poor for the receivables rather than inventory. Answer d indicates that internal control over inventory is actually good. Only c has internal control for inventory as relatively weak.

KEY TAKEAWAY

All companies operate by means of numerous systems that carry out designated tasks, such as the collection of cash and the payment of purchases. These systems need to be well designed and function as intended to protect company assets and reduce the chance of material misstatements in the financial records. Additional policies and procedures are included at important junctures in these systems to ensure that they operate appropriately. All such safeguards make up the company's internal control system. The independent auditor evaluates the quality of the internal control that is found in the various systems. If the risk of material misstatement has been reduced as a result of the internal control in a particular system, less audit testing is required.

6.5 The Purpose and Content of an Independent Auditor's Report

LEARNING OBJECTIVES

At the end of this section, students should be able to meet the following objectives:

1. Describe the purpose of the independent auditor's report.
2. Identify the intended beneficiaries of an independent auditor's report.
3. Discuss the contents of the introductory, scope, and opinion paragraphs in an independent auditor's report.
4. List problems that might require a change in the contents of an independent auditor's report.

The Structure of an Independent Auditor's Report

Question: At the conclusion of an audit, a report is issued by the CPA that will be attached to the financial statements for all to read. Much of this report is boilerplate: the words are virtually identical from one company to the next. What information is conveyed by an independent auditor, and what should a decision maker look for when studying an audit report?

Answer: The audit report accompanying the 2009 and 2010 financial statements for **The Procter & Gamble Company** is shown next.

To the Board of Directors and Shareholders of The Procter & Gamble Company

We have audited the accompanying Consolidated Balance Sheets of The Procter & Gamble Company and subsidiaries (the "Company") as of June 30, 2010 and 2009, and the related Consolidated Statements of Earnings, Shareholders' Equity, and Cash Flows for each of the three years in the period ended June 30, 2010. 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 the accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. 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 the Company at June 30, 2010 and 2009, and the results of its operations and cash flows for each of the three years in the period ended June 30, 2010, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of June 30, 2010, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 13, 2010 expressed an unqualified opinion on the Company's internal control over financial reporting.

Deloitte & Touche LLP

Cincinnati, Ohio

August 13, 2010

To understand the role of the independent audit within the financial reporting process, a considerable amount of information should be noted in the **audit report**[16] attached to the financial statements issued by **Procter & Gamble**.

16. Formal written opinion issued by an independent auditor to communicate findings at the conclusion of an audit as to indicate whether a specific set of financial statements contains any material misstatements according to U.S. GAAP; if not, the statements are viewed as fairly presented.

1. The report is addressed to the board of directors (elected by the shareholders) and the shareholders. An audit is not performed for the direct benefit of the reporting company or its management but rather for any person or group studying the financial statements for decision-making purposes. The salutation stresses that external users (rather than the company itself) are the primary beneficiaries of the work carried out by the independent auditor.

Interestingly, independent auditors are paid by the reporting company. The concern is raised periodically as to whether an auditor can remain properly independent of the organization that is providing payment for the services rendered. However, audit examinations can be quite expensive and no better method of remuneration has yet been devised.

2. To avoid any potential misunderstanding, the first (introductory) paragraph identifies the specific financial statements to which the report relates. In addition, both the responsibility of the management for those financial statements and the responsibility of the independent auditor for providing an opinion on those statements are clearly delineated. The statements are not created by the auditor; that is the job of management. The auditor examines the financial statements so that an expert opinion can be rendered.
3. The second (scope) paragraph provides information to explain the audit work. One key sentence in this paragraph is the second. It spells out the purpose of the audit by referring to the standards created by the PCAOB: "Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements." This sentence clearly sets out the goal of an audit engagement and the level of assurance given by the auditor. No reader should expect absolute assurance.

   The remainder of the second paragraph describes in general terms the steps taken by the auditor, such as:

   - Examine evidence on a test basis to support reported amounts and disclosures.
   - Assess the accounting principles that were applied.
   - Assess significant estimations used in creating the statements.
   - Evaluate overall presentation.
4. The third (opinion) paragraph provides the auditor's opinion of the financial statements. In this illustration, an **unqualified opinion**[17] is issued meaning that no problems worthy of note were discovered. The auditor provides the reader with reasonable assurance: "In our opinion, such consolidated financial statements present fairly, in all material respects...in conformity with accounting principles generally accepted in the United States of America." Through this sentence, the independent auditor is adding credibility to the financial statements. The auditor believes readers can rely on these statements in making their financial decisions.
5. The fourth (explanatory) paragraph provides an additional opinion by the auditor, this time in connection with the company's internal control. Such an assessment is required when an audit is performed on

17. An audit opinion informing the reader that attached financial statements are presented fairly, in all material respects, in accordance with U.S. GAAP; thus, the auditor is providing reasonable assurance that the statements contain no material misstatements according to U.S. GAAP and can be relied on by the reader in making financial decisions.

a company that is subject to the rules of the PCAOB. Not only is the auditor asserting that the financial statements are presented fairly in conformity with U.S. GAAP (paragraph 3) but also gives an unqualified opinion on the company's internal control over its financial reporting (paragraph 4). This additional assurance provides the reader with another reason to place reliance on the accompanying financial statements.

Qualified Audit Opinions

Question: The audit report presented for Procter & Gamble is an unqualified opinion. The independent auditor is providing reasonable assurance to decision makers that the company's financial statements are presented fairly, in all material respects, in conformity with U.S. GAAP. What can cause an independent auditor to issue an audit report that is less than an unqualified opinion and how is that report physically different?

Answer: An independent auditor renders an opinion that is not unqualified in two general situations:

- Lack of evidence. The auditor was not able to obtain sufficient evidence during the audit to justify an unqualified opinion. Perhaps the amount reported for a building or a liability could simply not be substantiated to the auditor's satisfaction. The balance might well be fairly presented according to U.S. GAAP but evidence was not available to allow the auditor to make that assertion with reasonable assurance.
- Presence of a material misstatement. The auditor discovered the existence of a material misstatement in the financial statements, a balance or disclosure that does not conform to U.S. GAAP. Because of the potential damage to the credibility of the financial statements, reporting companies usually make any adjustments necessary to eliminate such misstatements. If not, though, the auditor must clearly warn readers of the reporting problems.

The physical changes made in the report depend on the type of problem that is involved and its magnitude. The key method of warning is that a new paragraph is added between the scope and the opinion paragraphs to describe the auditor's concern. Decision makers often scan the audit report solely to see if such a paragraph is contained. If present, a careful reading of its contents (as well as related changes found in the wording of the opinion paragraph) should be made to determine the possible ramifications. Whether evidence was lacking or a material misstatement was uncovered, the auditor is responsible for letting the reader know. The presence of an added paragraph—prior to the opinion paragraph—always draws attention.

KEY TAKEAWAY

Upon completion of an audit, the independent auditor's report is attached to the financial statements. It is provided for the benefit of external decision makers. The financial statements are identified and the second (scope) paragraph provides an explanation of the audit process. If no problems are encountered, the report is said to be unqualified, and the opinion paragraph provides reasonable assurance to readers that the financial statements are presented fairly because no material misstatements are present according to U.S. GAAP. A qualification arises if the auditor is not able to obtain a satisfactory amount of evidence or if a material misstatement is found. Information about any such problem is then inserted into the audit report between the second (scope) paragraph and the third (opinion) paragraph.

Talking with a Real Investing Pro (Continued)

Following is a continuation of our interview with Kevin G. Burns.

Question: An independent audit is extremely expensive for any reporting company. As an investor, is the benefit gained from seeing the independent auditor's report attached to a set of financial statements actually worth the cost that must be incurred by the company?

Kevin Burns: I think the answer to this question is fairly obvious given the recent scandals, especially in the hedge fund world. An independent audit is absolutely critical for a corporation no matter what the expense. It is an exciting time to be in the accounting profession as investors are demanding additional transparency and independent oversight. Market confidence will be even more critical than usual for any business that wants to obtain money by issuing its equity shares and debt instruments. An internal audit would be perceived as self serving and untrustworthy and perception is 90 percent of reality, especially in today's cynical environment. Given the recent meltdown of financial institutions and stock prices, investors have a right to feel cynical and demand even more assurance before risking their money.

Video Clip

(click to see video)

Professor Joe Hoyle talks about the five most important points in Chapter 6 "Why Should Decision Makers Trust Financial Statements?".

6.6 End-of-Chapter Exercises

QUESTIONS

1. Why do people and organizations need to have trust in the financial reporting process?
2. What is the Securities and Exchange Commission (SEC)?
3. What types of companies fall under the jurisdiction of the SEC?
4. According to the SEC, who has the responsibility for setting generally accepted accounting principles in the United States (U.S. GAAP)?
5. What is the purpose of the *Accounting Standards Codification*?
6. What is a Form 10-K and a Form 10-Q?
7. Within the SEC, what is the purpose of EDGAR?
8. What role in the setting of financial accounting standards is played by the Emerging Issues Task Force (EITF)?
9. Why does the SEC not examine all the submitted financial statements to ensure their fair presentation?
10. Why must public companies hire an independent auditing firm before they submit their financial statements to the SEC?
11. Why do nonpublic companies often have their financial statements audited?
12. What is a CPA? How does a person become a CPA?
13. What organization regulates and sets the standards for the firms that audit public companies?
14. What legislation established the Public Company Accounting Oversight Board (PCAOB)?
15. What organization sets the standards for the firms that do not audit public companies?
16. An independent auditor examines the financial statements prepared by the management of Simon Corporation. Who is the primary beneficiary of the audit work?
17. An independent auditor examines the financial statements prepared by the management of Garfunkel Corporation. The auditor believes the financial information is fairly presented according to U. S. GAAP. What type of assurance does the auditor provide?
18. Why do auditors not provide absolute assurance that examined financial statements are presented fairly according to U.S. GAAP?
19. What are internal controls?
20. How is an auditor's work affected by the presence and quality of a company's internal controls?
21. What is an unqualified audit opinion?
22. Why might an auditor include an explanatory paragraph in an audit report between the scope paragraph and the opinion paragraph?
23. Under what conditions does an auditor not render an unqualified opinion?

TRUE OR FALSE

1. ____ The Howard Company has exceptionally good internal control. The quality of that internal control has no effect on the work of the company's independent auditor.
2. ____ An accountant becomes a CPA based on federal rules and regulations.
3. ____ A person who works as an accountant for a significant number of years becomes known as a CPA.
4. ____ The SEC is the current accounting standard-setting body in the United States.
5. ____ The inclusion of an added paragraph in an audit report after the scope (second) paragraph indicates that the financial statement contains a material misstatement.
6. ____ The PCAOB oversees the work of CPAs who audit companies that issue publicly traded securities.
7. ____ Nonpublic companies rarely have an audit performed on their financial statements because they do not issue publicly traded securities.
8. ____ The Auditing Standards Board works under FASB to resolve relatively simple issues.
9. ____ The Red Company creates a new type of transaction and is not sure how to apply current U.S. GAAP for its reporting. The EITF might be called on to provide guidance.
10. ____ Janice Hough serves as an investment analyst for a number of wealthy clients. She is likely to make use of EDGAR.
11. ____ The *Accounting Standards Codification* is one portion of U.S. GAAP.
12. ____ Audits are paid for by the creditors and investors of a company that receive the actual benefit of the CPA's work.
13. ____ A CPA firm rarely has more than 100 auditors in its employment.
14. ____ The term "presents fairly" means that the financial information contained in a set of financial statements is correct.
15. ____ FASB is a governmental agency that works under the jurisdiction of the SEC.

MULTIPLE CHOICE

1. Whittington and Company is a CPA firm that audits publicly traded companies in the state of Oregon. Which of the following is true concerning Whittington and Company?

    a. Whittington and Company is regulated by FASB.
    b. Whittington and Company is hired by the companies that the firm audits.
    c. Whittington and Company should follow the auditing standards set forth by the Auditing Standards Board (ASB).
    d. Whittington and Company prepares the financial statements for the companies that the firm audits.

2. Which of the following is **not** true about an audit report?

    a. An extra paragraph inserted after the scope paragraph indicates that the auditor has given something other than an unqualified opinion.
    b. If a material misstatement is discovered in the financial statements, the auditor should not issue an unqualified opinion.
    c. The report is addressed to the company's board of directors and shareholders.
    d. To ensure that the opinion is properly noted, it is provided in the very first sentence of the first paragraph.

3. Which of the following is true about the Financial Accounting Standards Board (FASB)?

    a. FASB sets standards that apply to companies throughout the world.
    b. FASB was created by the EITF to handle smaller issues in a timely manner.
    c. FASB produces accounting standards that apply to virtually all companies in the United States.
    d. FASB was created by the Securities Exchange Act of 1934.

4. Which organization is a governmental entity?

a. SEC
b. FASB
c. EITF
d. ASB

5. Which of the following is true about the Securities and Exchange Commission (SEC)?

    a. The SEC sets accounting standards in the United States.
    b. The SEC was not given any enforcement powers by the U.S. Congress.
    c. The SEC was charged with ensuring that adequate and fair information is made available about publicly traded companies.
    d. The SEC is an international agency that monitors financial reporting around the world.

6. Which of the following is true about the PCAOB?

    a. It regulates firms that audit companies that issue publicly traded securities.
    b. It sets accounting standards for smaller U.S. companies.
    c. It was created in 1934 during the Great Depression.
    d. Its standards apply to all companies within the United States.

7. An independent auditor provides an unqualified opinion on the financial statements of the O'Neil Corporation. Which of the following statements is true?

    a. The auditor must have followed the standards produced by the Auditing Standards Board (ASB).
    b. The first paragraph of the audit report indicates the auditor's responsibility and the company's responsibility.
    c. The SEC oversees the financial reporting by O'Neil.
    d. An added paragraph before the scope paragraph indicates that the auditor has not provided an unqualified audit opinion.

8. Which of the following is not a reason why an auditor only provides reasonable assurance in an audit report?

a. Financial statements contain numerous estimations.
b. The sheer volume of transactions means that the auditor cannot examine every transaction or other event.
c. U.S. GAAP have only been produced since 2002 and do not cover all possible transactions.
d. Fraud can be hidden from the independent auditor by the management of the reporting company.

9. Which of the following is not necessary to become a Certified Public Accountant (CPA)?

a. A specified amount of education
b. Two years of work with one of the Big Four firms
c. A passing grade on every part of the CPA Exam
d. Practical experience

VIDEO PROBLEMS

Professor Joe Hoyle discusses the answers to these two problems at the indicated links. After formulating your answers, watch each video to see how Professor Hoyle answers these questions.

1. Your roommate is an English major. The roommate's parents own a chain of ice cream shops throughout Florida. One day, on the way to a psychology class, your roommate poses this question: "Each year, my parents produce a set of financial statements for their business. The statements look great. Then, after all the work is finished, they go out and hire a CPA who charges them a hefty fee. That seems like such a waste of money. The financial statements have already been prepared before the CPA ever shows up. What are they getting for their money?" How would you respond?

(click to see video)

2. Your uncle and two friends started a small office supply store several years ago. The company has expanded and now has several large locations. Your uncle knows that you are taking a financial accounting class and asks you the following question: "Our growth has been moving forward very nicely. We have an excellent business that is poised to continue getting bigger. Recently, our accountant came to us and indicated that we would need to start following the rules and regulations of the Securities and Exchange Commission. I realize that this can be time consuming and costly. Why do we need to worry about the SEC now when we have not had to do so in the past?" How would you respond?

(click to see video)

PROBLEMS

1. Match the following organizations to their descriptions.

   - ____ FASB
   - ____ PCAOB
   - ____ SEC
   - ____ EITF
   - ____ ASB

   a. Sets auditing standards for auditors of publicly traded companies
   b. Sets U.S. Generally Accepted Accounting Principles
   c. Helps apply U.S. Generally Accepted Accounting Principles to new situations
   d. Sets auditing standards for auditors of private companies
   e. Created by the Securities Exchange Act of 1934 to protect investors
2. In an unqualified audit report, the first three paragraphs are the introductory paragraph, scope paragraph, and opinion paragraph. Describe the purpose of each and list several items included in each.
3. Explain the difference between the work of the PCAOB and the ASB.
4. Explain the difference between the work of the EITF and FASB.
5. Provide a short description of the role that each of the following plays in the financial reporting process.

   - FASB
   - Big Four
   - Unqualified audit opinion
   - EDGAR
   - Internal control

RESEARCH ASSIGNMENTS

1. The role of the CPA in the world of business is often misunderstood. Go to the Web site http://www.thisway2cpa.com. On the left side of the homepage, there are several links including "The Profession," "Education," "Career Tools," and "Exam & Licensure." Click on the link that seems most interesting. Make a list of four things that you learned by exploring the information provided through the chosen link.

2. Assume that you take a job as a summer employee for an investment advisory service. Your boss tells you that you need to learn to use the SEC Web site and EDGAR to locate information about various companies. For example, the boss wants to know whether the inventory held by **PepsiCo** increased or decreased between 2009 and 2010. That information will be found in the Form 10-K, which is the annual report filed by the company with the SEC. To get started, the boss jots down the following steps to find that desired piece of information. Follow the steps and determine the change. The boss also gives one more suggestion: "As you search through the Form 10-K for this company, start to notice all of the other types of information that are readily available to help us understand this company, its financial health and future prospects."

   a. Go to http://www.sec.gov.
   b. Scroll down to "Filings & Forms."
   c. Click on "Search for Company Filings."
   d. Click on "Company or fund name, ticker symbol, CIK (Central Index Key), file number, state, country, or SIC (Standard Industrial Classification)."
   e. Type in "**PepsiCo**" in the "Company Name" box and click on "Find Companies."
   f. On the "Filter Results" line, type "10-K" into the "Filing Type" box and type "20110701" into the "Prior to" box and click on "Search."
   g. The top line for the list of filings should be the 10-K that was filed by the company on 2011-02-18. Click on the "Documents" link for that 10-K.
   h. On the top line is listed the original 10-K filed on that date. Click on the link "d10k.htm."
   i. The original Form 10-K filed by **PepsiCo** for the fiscal year ended December 25, 2010, should appear.

j. Scroll to page 75 and find the consolidated balance sheet for 2010 and 2009. Determine the amount of inventory reported by **PepsiCo** as of the end of both of these years and the increase or decrease that took place.