Chapter 17

Multiple Choice

1. Footnotes to financial statements should not be used to
   a. Describe the nature and effect of a change in accounting principles
   b. Identify substantial differences between book and tax income
   c. Correct an improper financial statement presentation
   d. Indicate bases for valuing assets

Answer c

2. Assuming that none of the following have been disclosed in the financial statements, the most appropriate item for footnote disclosure is the
   a. Collection of all receivables subsequent to year end
   b. Revision of employees' pension plan
   c. Retirement of president of company and election of new president
   d. Material decrease in the advertising budget for the coming year and its anticipated effect upon income

Answer b

3. The primary responsibility for the adequacy of disclosure in the financial statements and footnotes rests with the
   a. Partner assigned to the engagement
   b. Auditor in charge of fieldwork
   c. Staff who draft the statements and footnotes
   d. Client

Answer d

4. Which of the following situations would require adjustment to or disclosure in the financial statements?
   a. A merger discussion
   b. The application for a patent on a new production process
   c. Discussions with a customer that could lead to a 40 percent increase in the client's sales
   d. The bankruptcy of a customer who regularly purchased 30 percent of the company's output

Answer d

5. With respect to disclosure, the unqualified short-form audit report
   a. States that disclosure is adequate in the financial statements including the footnotes thereto
   b. States that disclosure is sufficiently adequate to make the statements not misleading

c. States that all material items are disclosed in conformity with the generally accepted accounting principles
d. Implies that disclosure is adequate in the financial statements including the footnotes thereto

Answer c

6. Which of the following should be disclosed in the Summary of Significant Accounting Policies?
   a. Composition of plant assets
   b. Pro forma effect of retroactive application of an accounting change
   c. Basis of consolidation
   d. Maturity dates of long-term debt

Answer c

7. An Account Principles Board Opinion was concerned with disclosure of accounting policies. A singular feature of this particular opinion is that it
   a. Calls for disclosure of every accounting policy followed by a reporting entity
   b. Applies to immaterial items whereas most opinions are concerned solely with material items
   c. Applies also to accounting policy disclosures by not-for-profit entities, whereas most opinions are concerned solely with accounting practices of profit-oriented entities
   d. Prescribes a rigid format for the disclosure of policies to be reported upon

Answer c

8. Significant accounting policies may not be
   a. Selected on the basis of judgment
   b. Selected from existing acceptable alternatives
   c. Unusual or innovative in application
   d. Omitted from financial statement disclosure on the basis of judgment

Answer d

9. The stock of Gates, Inc., is widely held, and the company is under the jurisdiction of the Securities and Exchange Commission. In the annual report, information about the significant accounting policies adopted by Gates should be
   a. Omitted because it tends to confuse users of the report
   b. Included as an integral part of the financial statements
   c. Presented as supplementary information
   d. Omitted because all policies must comply with the regulations of the Securities and Exchange Commission

Answer b

10. The basic purpose of the securities laws of the United States is to regulate the issue of investment securities by
    a. Providing a regulatory framework in those states which do not have their own securities laws
    b. Requiring disclosure of all relevant facts so that investors can make informed decisions
    c. Prohibiting the issuance of securities which the Securities and Exchange Commission determines are not of investment grade
    d. Channeling investment funds into uses which are economically most important

    Answer b

11. The Securities and Exchange Commission (SEC) was established in1934 to help regulate the U.S. securities market. Which of the following statements is true concerning the SEC?
    a. The SEC prohibits the sale of speculative securities.
    b. The SEC regulates only securities offered for public sale.
    c. Registration with the SEC guarantees the accuracy of the registrant's prospectus.
    d. The SEC's initial influence and authority has diminished in recent years as the stock exchanges have become more organized and better able to police themselves.

Answer b

12. One of the major purposes of federal security regulation is to
    a. Establish the qualifications for accountants who are members of the profession
    b. Eliminate incompetent attorneys and accountants who participate in the registration of securities to be offered to the public
    c. Provide a set of uniform standards and test for accountants, attorneys, and others who practice before the Securities and Exchange Commission
    d. Provide sufficient information to the investing public who purchases securities in the marketplace

Answer d

13. Under the Securities Act of 1933, subject to some exceptions and limitations, it is unlawful to use the mails or instruments of interstate commerce to sell or offer to sell a security to the public unless
    a. A surety bond sufficient to cover potential liability to investors is obtained and filed with the Securities and Exchange Commission
    b. The offer is made through underwriters qualified to offer the securities on a nationwide basis
    c. A registration statement has been properly filed with the Securities and Exchange Commission, has been found to be acceptable, and is in effect
    d. The Securities and Exchange Commission approves of the financial merit of the offering

Answer c

14. Major, Major, and Sharpe, CPA's, are the auditors of MacLain industries. In connection with the public offering of $10 million of MacLain securities, Major expressed an unqualified opinion as to the financial statements. Subsequent to the offering, certain misstatements and omissions are revealed. Major has been sued by the purchasers of the stock offered pursuant to the registration statement, which include the financial statements audited by Major. In the ensuing lawsuit by the MacLain investors, Major will be able to avoid liability if
    a. The errors and omissions were caused primarily by MacLain
    b. It can be shown that at least some of the investors did not actually read the audited financial statements
    c. It can prove due diligence in the audit of the financial statements of MacLain
    d. MacLain had expressly assumed any liability in connection with the public offering

Answer c

15. A major impact of the Foreign Corrupt Practices Act of 1977 is that registrants subject to the Securities Exchange Act of 1934 are now required to
    a. Keep records which reflect the transactions and dispositions of assets and maintain a system of internal accounting controls
    b. Provide access to records by authorized agencies of the federal government
    c. Records all correspondence with foreign nations
    d. Prepare financial statements in accordance with international accounting standards

Answer a

16. The Securities and Exchange Commission's fraud rule prohibits trading on the basis of inside information of a business corporation's stock by
    a. Officers
    b. Officers and directors
    c. All officers, directors, and stockholders
    d. Officers, directors, and beneficial holders of 10 percent of the corporation's stock

Answer d

17. A CPA is subject to a criminal ability if the CPA
    a. Refuses to turn over the working papers to the client
    b. Performs an audit in a negligent manner
    c. Willfully omits a material fact required to be stated in a registration statement
    d. Willfully breaches the contract with the client

Answer c

18. For interim financial reporting, an inventory loss from a temporary market decline in the first quarter which can reasonably be expected to be restored in the fourth quarter

a. Should be recognized as a loss proportionately in each of the first, second, third, and fourth quarters
b. Should be recognized as a loss proportionately in each of the first, second, and third quarters
c. Need *not* be recognized as a loss in the first quarter
d. Should be recognized as a loss in the first quarter

Answer c

19. An inventory loss from a market decline occurred in the first quarter that was not expected to be restored in the fiscal year. For interim financial reporting purposes, how would the dollar amount of inventory in the balance sheet be affected in the first and fourth quarters?

	First Quarter	*Fourth Quarter*
a.	Decrease	No effect
b.	Decrease	Increase
c.	No effect	Decrease
d.	No effect	No effect

Answer a

20. Footnotes to a company's financial statements are used to
a. More fully explain certain items in the financial statements.
b. Reflect financial notes personalized by the company's executive team.
c. Show the detail of salaries of every employee.
d. Justify fraudulent business practices.

Answer a

21. The statement that "the financial statements were prepared in accordance with generally accepted accounting principles" is found in the
a. Management letter
b. Management discussion and analysis
c. Footnotes to the balance sheet.
d. Auditor's report.

Answer d

22. According to the disclosure requirements outlined in *Statement of Accounting Concepts No. 5,* the following is an example supplementary information that should be disclosed because it affects an area that is directly affected by existing FASB Standards
a. Management discussion and analysis.
b. Segment information.
c. Accounting policies.
d. A statement of cash flows.

Answer b

23. Norris Company settled a lawsuit in February for an amount that was significantly different from the amount that was originally accrued as an estimate of potential loss. The company's yearend is December 31 and its financial statements are issued in March. This is an example of
    a. A subsequent event that must be disclosed, but because it happened after the balance sheet date no adjustment is needed .
    b. A subsequent event that provided evidence of a condition that did not exist at the balance sheet date.
    c. A subsequent event that need not be disclosed because it did not occur before the company's yearend.
    d. A subsequent event that provided further evidence of conditions that existed on the balance sheet.

Answer d

24. Footnote disclosure that summarizes information that does not meet the measurement and reporting requirements for presentation in a company's financial statements, but is useful to informed readers, is required in order to meet the concept of
    a. Understandability.
    b. Reliability.
    c. Representational faithfulness.
    d. Cost/benefit.

Answer a

25. The inclusion of MD&A (Management Discussion and Analysis) in annual reports is required by the
    a. FASB.
    b. AICPA.
    c. SEC.
    d. APB.

Answer c

26. Which SEC reporting form is the normal registration statement for securities to be sold to the public?
    a. Form 10.
    b. Form 10-K.
    c. Form 10-Q.
    a. Proxy Statement.

Answer a

27. The Sarbanes-Oxley (SOX) Act of 2002 created the PCAOB. The PCAOB
    a. Is primarily responsible for establishing generally accepted accounting principles.

b. Provides legal and expert services to CPA firms when they are involved in class-action law suits.
c. Oversees the conduct of acts that are intended to influence, coerce, manipulate, or mislead a CPA when he/she is preparing a company's financial statements.
d. Oversees audits of companies whose securities are public traded.

Answer d

28. A disclaimer of opinion is issued when
    a. All informative disclosures have not been made in the financial statements.
    b. Circumstances prevent the auditor from performing all audit procedures necessary to comply with generally accepted auditing standards.
    c. The financial statements are not prepared in accordance with generally accepted accounting principles.
    d. There is a potential going concern issue.

Answer b

29. The discrete view of interim reporting
    a. Holds that an interim period is a separate accounting period; thus, revenues and expenses should be treated as though they occurred only in one period.
    b. Holds that revenues and expenses should be allocated to the various interim periods.
    c. Holds that revenues and expenses should be reported as they occur.
    d. Holds that an interim period is an integral part of the annual reporting period.

Answer a

30. The Securities act of 1933
    a. Regulates the trading of securities of publicly held companies.
    b. Regulates the initial public sale and distribution of a corporation's securities.
    c. Addresses the personal duties of corporate officers.
    d. Specifies information that is to be contained in a company's annual report.

Answer b

31. The Sarbanes-Oxley (SOX) Act of 2002 created the PCAOB. The PCAOB

    a. Is primarily responsible for establishing generally accepted accounting principles.
    b. Provides legal and expert services to CPA firms when they are involved in class-action law suits.
    c. Oversees the conduct of acts that are intended to influence, coerce, manipulate, or mislead a CPA when he/she is preparing a company's financial statements.
    d. Oversees audits of companies whose securities are public traded.

Answer d

Essay

1. List the building blocks to disclosure described in SFAC No. 5.

   SFAC No. 5 summarizes the building blocks to disclosure as:

   1. The scope of recognition and measurement
   2. Basic financial statements
   3. Areas directly affected by existing FASB standards
   4. Financial reporting
   5. All information useful for investment, credit, and similar decisions.

2. List and discuss the types of information commonly disclosed in the footnotes to corporate financial statements.

   The footnotes to a company's financial statements provide a significant amount of additional information about the items on the company's financial statements. In general, the footnotes disclose information that explains, clarifies, or develops items appearing on the financial statements, which cannot easily be incorporated into the financial statements themselves. The most common examples of footnotes are:

   a. Accounting policies. *APB Opinion No. 22*, "Disclosure of Accounting Policies" (See FASB ASC 235), required all companies to disclose both the accounting policies the firm follows and the methods it uses in applying those policies. Typically, companies disclose this information in a Summary of Significant Accounting Policies preceding the footnotes. Specifically, *APB Opinion No. 22* required that the accounting methods and procedures involving the following be disclosed:

      i. A selection from existing acceptable alternatives.

      ii. Principles and methods peculiar to the industry in which the reporting entity operates.

      iii. Unusual or innovative applications of GAAP.

   b. Schedules and exhibits. —Firms typically report schedules or exhibits concerning long-term debt and income tax, for example. The purpose of supplementary schedules is to improve the understandability of the financial statements. They may be used to highlight trends, such as five-year summaries; or they may be required by FASB pronouncements, such as information on current costs.

   c. Explanations of financial statement items. —Some items require additional explanation so that users can make sense of the reported information. Pensions and postretirement benefits are two examples. Parenthetical disclosures are contained on the face of the financial statements (usually on the balance sheet). They are generally used to describe the valuation basis of a particular financial statement element but also may provide other kinds of information, such as the par value and number of shares authorized and issued for various classes of a company's stock

   d. General information about the company. —Occasionally, firms face events that may impact their financial performance or position but cannot yet be recognized on the financial

statements. In that case, investors have an interest in learning this information as soon as possible. Information concerning subsequent events and contingencies are two examples.

3. List and discuss the recognition criteria for the two types of subsequent events.

   These events are referred to as "subsequent events," and may be either (1) events that provide further evidence of conditions that existed on the balance sheet date or (2) events that provide evidence of conditions that did not exist at the balance sheet date.
   GAAP requires events in the first category to be reported on the company's financial statements. In other words, when a company experiences an event after the balance sheet date, but before it issues its financial statements, that provides further evidence of some condition existing at the balance sheet date, it is required to adjust its records to reflect the financial impact of that condition. If, for example, a company settles litigation for an amount significantly different than the amount it had originally accrued, then it must adjust the amount it originally accrued and report the adjusted accrual on the financial statements. The adjusted disclosure is required because the event that gave rise to the adjustment occurred before the balance sheet date. If such an adjustment were not made, then the financial statements would not fully reflect the true financial condition at the balance sheet date or performance of the company that occurred during the fiscal year.

   On the other hand, GAAP does not require adjustments to the financial statements for category 2 events. But we should note that companies frequently disclose these events in the footnotes to their financial statements. These footnote disclosures allow the company to discuss the impact of the new information. Companies often disclose this type of subsequent event when they issue debt or equity securities, incur casualty losses, sell significant assets, or settle litigation initiated as the result of events that occurred after the balance sheet date

4. List and discuss the three paragraphs contained in a standard unqualified audit option.

   An unqualified, audit report that contains three sections:

   1. An opening paragraph that indicates an audit was performed and includes a statement that the financial statements are the responsibility of management.
   2. A scope paragraph that indicates the audit was performed in accordance with generally accepted auditing standards.
   3. An opinion paragraph that states the financial statements are presented fairly in accordance with generally accepted accounting principles.

5. List and discuss the circumstances that might cause an auditor to issue each of the various types of audit opinions.

   1. The auditor will issue an unqualified opinion when he or she is satisfied the financial statements are presented "fairly" and in conformity with GAAP.
   2. Qualified opinion. —This type of audit report indicates that except for the effects to which the qualification relates, the financial statements are presented fairly. A qualified audit opinion is issued when
      a. Circumstances prevent the auditor from performing all audit procedures necessary to comply with generally accepted auditing standards,

b. The financial statements contain a material departure form GAAP, or
c. All informative disclosures have not been made in the financial statements.

3. Disclaimer of opinion. —This type of opinion states that the auditor does not express an opinion on the financial statements because
   a. The auditor cannot gather all of the necessary evidence, or
   b. There is concern about the ability of the company to continue as a going concern.
4. Adverse opinion. —This type of opinion results when the statements are not prepared in accordance with generally accepted accounting principles.
5. *Auditor's report on internal controls.* Following the enactment of the Sarbanes–Oxley Act of 2002, the Public Company Accounting Oversight Board (PCAOB) was established to monitor and regulate audits of public companies (discussed later in the chapter).The PCAOB now requires auditors of public companies to include additional disclosures and form an opinion regarding the auditee's internal controls and to opine about the company's and auditor's assessment on the company's internal controls over financial reporting. These new requirements have modified the audit opinion to include all necessary disclosures by either presenting the report subsequent to the audit report on the financial statements or combining both reports into one auditor's report.
6. *Going concern opinion.* The going concern assumption is a basic accounting principle. This assumption means that an entity is expected continue to operate in the near future. Auditing standards require auditors to evaluate the conditions or events discovered during an audit that raise questions about the validity of the going-concern assumption. An auditor who concludes that substantial doubt exists about the entity's ability to continue as a going concern and who is not satisfied that management's plans are enough to mitigate these concerns is required to issue a modified (but unqualified) report. If the auditor considers that the auditee is not a going concern, or will not be a going concern in the near future, the auditor is required to include an explanatory paragraph before the opinion paragraph or following the opinion paragraph, in the audit report explaining the situation. Additionally, financial statement users make judgments throughout the year about a company's prospects. Thus, they would benefit from disclosures by the company in its interim and annual financial statements of factors that could affect the going concern assumption.

6. In April 2013, the FASB issued Accounting Standards Update 2013-07, Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting.
7.
   a. Define the term liquidation as used in this pronouncement.

   Liquidation is defined as "the process by which an entity converts its assets to cash or other assets and partially or fully settles its obligations with creditors in anticipation of the entity ceasing its operations." 4 Liquidation is considered to be imminent when either of the following situations occurs:

   1. A plan for liquidation has been approved by the person or persons with the authority to make such a plan effective and the likelihood is remote that the execution of the plan will be blocked by other parties.
   2. A plan for liquidation is being imposed by other forces (for example, involuntary bankruptcy) and the likelihood is remote that the entity will subsequently return from liquidation.

   b. What information does the ASU require to be disclosed by entities subject to its provisions?

   The ASU also requires financial statements prepared using the liquidation basis to reflect relevant information about an entity's resources and obligations in liquidation by measuring and

presenting assets and liabilities in the entity's financial statements as the amount of cash or income that it expects to earn during the expected duration of the liquidation, including any costs associated with settlement of those assets and liabilities. These financial statements should include:

1. *Statement of Changes in Net Assets in Liquidation:* A statement that includes information about the changes during the period in net assets or other consideration that the entity expects to pay during the course of liquidation
2. *Statement of Net Assets in Liquidation:* A statement that includes information about the net assets available for distribution to investors and other claimants during liquidation as of the end of the reporting period'

The ASU also requires disclosures about the entity's plan for liquidation, the methods and significant assumptions used to measure assets and liabilities, the type and amount of costs and income accrued, and the expected duration of liquidation.
Entities should apply the requirements prospectively from the day that liquidation becomes imminent

8. What information is required to be included in the MD & A section of the 10-K annual report? (Do not include the information required by item 7a)

   Basically, the MD&A section evaluates the causes and explains the reasons for a company's performance during its preceding annual period. The required disclosures include information about liquidity, capital resources, and the results of operations. The SEC also requires management to highlight favorable or unfavorable trends and to identify significant events or uncertainties that affect those three factors. Since a company must disclose matters that could affect its financial statements in the future, the MD&A allows financial statement users to evaluate a company's past performance and its likely impact on future performance

9. Define market risk and the types of market risk to be disclosed in item &a of a company's MD&A.

   Market risk is defined as the risk of loss arising from adverse changes in market rates and prices from such items as:
   1. Interest rates
   2. Currency exchange rates
   3. Commodity prices
   4. Equity prices

10. How is the quantitative information about market risk–sensitive instruments to be disclosed according to the SEC?

    The quantitative information about market risk–sensitive instruments is to be disclosed by using one or more of the following alternatives:

    1. Tabular presentation of fair value information and contract terms relevant to determining future cash flows, categorized by expected maturity dates.

    2. Sensitivity analysis expressing the potential loss in future earnings, fair values, or cash flows from selected hypothetical changes in market rates and prices.

3. Value at risk disclosures expressing the potential loss in future earnings, fair values, or cash flows from market movements over a selected period and with a selected likelihood of occurrence.

11. What are the purposes of the letter to stockholders?

Management's letter to the stockholders has four main purposes. It indicates that management:

1. Is responsible for preparation and integrity of statements.
2. Has prepared statements in accordance with GAAP.
3. Has used their best estimates and judgment.
4. Maintains a system of internal controls.

12. List and explain the three types of financial analysts.

Professional security analysts make investment analyses. They frequently specialize in certain industries, using their training and experience to process and disseminate information more accurately and economically than individual investors. There are three categories of financial analysts:

Sell side. —Work for full-service broker dealers and make recommendations on securities they cover. Many work for the most prominent brokerage firms, which also provide investment banking services to companies, including those whose securities the analysts cover.

Buy side. —Work for institutional money managers, such as mutual funds, that purchase securities for their own accounts. Counsel their companies to buy, hold, and sell.

Independent. —Not associated with firms that underwrite the securities they cover. Often sell their recommendations on a subscription basis.

13. Discuss the general purposes of:

a. The Securities Act of 1933

The Securities Act of 1933 regulates the initial public sale and distribution of a corporation's securities (going public). The goal of this legislation is the protection of the public from fraud when a company is initially issuing securities to the general public. The provisions of the Securities Act of 1933 require a company initially offering securities to file a registration statement and a prospectus with the SEC. The registration statement becomes effective on the twentieth day after filing unless the SEC requires amendments. This twenty-day period is termed the waiting period, and it is unlawful for a company to offer to sell securities during this period. The registration of securities under the provisions of the 1933 Act is designed to provide adequate disclosures of material facts to allow investors to assess the degree of potential risk. Nevertheless, registration does not completely protect investors from the possibility of loss, and it is unlawful for any company officials to suggest that registration prevents possible losses.

b. The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 regulates the trading of securities of publicly held companies (being public). This legislation addresses the personal duties of corporate officers and owners (insiders) and corporate reporting requirements, and it specifies information that is to be contained in the corporate annual reports and interim reports issued to shareholders. The Act established extensive reporting requirements to provide continuous full and fair disclosure. Each corporation that offers securities for sale to the general public must select the appropriate reporting forms. The most common reporting forms, all of which can be obtained from the SEC's Web site, are:

Form 10. —the normal registration statement for securities to be sold to the public.
Form 10-K. —the annual report.
Form 10-Q. —the quarterly report of operations.
Proxy statement. —used when a company makes a proxy solicitation for its stockholder meetings.

One of the major goals of the 1934 Act is to ensure that any corporate insider (broadly defined as any corporate officer, director, or 10 percent-or-more shareholder) does not achieve an advantage in the purchase or sale of securities because of a relationship with the corporation. It also established civil and criminal liabilities for insiders making false or misleading statements when trading corporate securities. The specific SEC reporting requirements for going public and being public are beyond the scope of this text; however, it should be noted that the SEC's stipulation that much of the information provided in the 10-K, 10-Q, and proxy reports must be certified by an independent certified public accountant has been a significant factor in the growth and importance of the public accounting profession in the United States.

c. The Foreign Corrupt Practices Act of 1977

The Foreign Corrupt Practices Act (FCPA) of 1977 contains two main elements. The first makes it a criminal offense to offer bribes to political or governmental officials outside the United States and imposes fines on offending firms. It also provides for fines and imprisonment of officers, directors, or stockholders of offending firms.
The second element of the FCPA is a requirement that all public companies must (1) keep reasonably detailed records that accurately and fairly reflect company financial activity and (2) devise and maintain a system of internal control that provides reasonable assurance that transactions were properly authorized, recorded, and accounted for. This element is an amendment to the Securities Exchange Act of 1934 and therefore applies to all corporations that are subject to the Act's provisions. The major goals of this legislation are the prevention of the bribery of foreign officials and the maintenance of adequate corporate financial records.

14. Discuss three general provisions of the Sarbanes-Oxley Act.

The students' answers should be based on the following:

Among the major provisions of this legislation are:

1. *The creation of the Public Company Accounting Oversight Board (PCAOB). —The PCAOB oversees audits of public companies that are subject to The Securities Act of 1933 and The Securities Exchange Act of 1934. The PCAOB contains five members appointed from among prominent individuals of integrity and reputation. These individuals must have a demonstrated commitment to the interests of investors and the public and an understanding of the responsibilities for the financial disclosures required in the preparation of financial statements and audit reports. The duties of the PCAOB include:*

   a. Registering public accounting firms that prepare audit reports.
   b. Establishing auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports.
   c. Conducting inspections of registered public accounting firms.
   d. Conducting investigations and disciplinary proceedings concerning and, where appropriate, imposing appropriate sanctions where justified upon registered public accounting firms and CPAs within those firms.
   e. Performing any other duties or functions necessary or appropriate to promote high professional standards among, and improve the quality of audit services offered by, CPA firms and CPAs within those firms.
   f. Enforcing compliance with the Securities Exchange Act of 1934.

   Among the PCAOB's powers are:

   a. To sue and be sued, complain and defend, in its corporate name and through its own counsel, with the approval of the SEC, in any federal, state, or other court.
   b. To conduct its operations and exercise all rights and powers authorized by the SEC, without regard to any qualification, licensing, or other provision of law in effect in any state or political subdivision.

2. *The establishment of auditing, quality control, and independence standards.* —The PCAOB is required to cooperate with various professional groups of CPAs related to the standard-setting process. The PCAOB may adopt standards proposed by the profession; however, it has the authority to amend, modify, repeal, and/or reject any standards suggested by the profession. Additionally, CPA firms are required to prepare, and maintain for a period of not less than seven years, audit work papers and other information in sufficient detail to support the conclusions reached in each of its audit reports. CPA firms must also use a second-partner review and approval of its audit reports. The PCAOB developed an audit standard to implement internal control reviews. This standard requires auditors to evaluate whether internal controls include records that accurately and fairly reflect transactions of the reporting entity and provide reasonable assurance that the transactions are recorded in a manner that will permit the preparation of financial statements in accordance with the technical literature; auditors must also disclose any material weaknesses in internal controls they discover during audits.

3. *The inspection of CPA firms.* —The PCAOB will conduct annual quality reviews for CPA firms that audit financial statements of more than 100 publicly traded entities. Other firms must undergo this quality review/inspection process every three years. The SEC and/or the PCAOB may order a special inspection of any CPA firm at any time.

4. *The establishment of accounting standards.* —The SEC is authorized to recognize as generally accepted accounting principles those that are established by a standard-setting body that meet all of the criteria within the Sarbanes-Oxley Act, which include requirements that the standard-setting body:

   a. Be a private entity.
   b. Be governed by a board of trustees or equivalent body, the majority of whom are not or have not been associated with a CPA firm within the two-year period preceding service on this board of trustees.
   c. Be funded in a manner similar to the PCAOB, through fees collected from CPA firms and other parties.
   d. Have adopted procedures to ensure prompt consideration of changes to accounting principles by a majority vote. Consider when adopting standards the need to keep the standards current and the extent to which international convergence of standards is necessary/appropriate.
5. *The delineation of prohibited services.* —The legislation makes it unlawful for a CPA firm to provide any nonaudit service to the reporting entity contemporaneously with the financial statement audit. Prohibited services include the following:
   a. Bookkeeping or other services related to the accounting records or financial statements of the reporting entity.
   b. Financial information systems design/implementation.
   c. Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.
   d. Actuarial services.
   e. Internal audit outsourcing services.
   f. Management functions or human resources.
   g. Broker/dealer, investor advisor, or investment banker services.
   h. Legal services and expert services unrelated to the audit, or any other service that the board rules is not permissible.
   The legislations allow the board, on a case-by-case basis, to provide an exemption to these prohibitions, subject to review by the SEC, and does not make it unlawful to provide other nonaudit services (those not prohibited) if those services are approved in advance by the audit committee. The audit committee must disclose to investors in periodic reports the decision to preapprove those services. The preapproval requirement is waived if the aggregate amount of the fees for all of the services provided constitutes less than 5 percent of the total amount of revenues paid by the issuer to the auditing firm.

6. Prohibition of acts that influence the conduct of an audit. The Act makes it unlawful for any officer or director of an entity to fraudulently influence, coerce, manipulate, or mislead a CPA performing an audit.

7. *Requiring specified disclosures.* —Each financial report must reflect all material correcting adjustments a CPA determines are necessary. Each annual or quarterly financial report must disclose all material off–balance sheet transactions and other relationships with unconsolidated entities that may have a material current or future effect on the financial condition of the entity. The SEC will issue rules providing that pro-forma financial information must be presented in a manner such that it does not contain an "untrue statement" or omit a material fact necessary in order for the information not to be misleading.

8. *Requiring CEO and CFO certification.* —CEOs and CFOs must certify in each annual and quarterly report that the officer has reviewed the report, that based on the officer's knowledge

the report does not contain any untrue statement of a material fact or omit a material fact, and that based on the officer's knowledge, the financial statements and other financial information included in the report fairly present the financial condition and results of operations of the issuer. They must also attest that they are responsible for establishing and maintaining internal controls, that they have designed such controls to ensure that material information is made known to the officers, that they have presented their conclusions about the effectiveness of those controls in the report, and that they have disclosed both to the outside auditors and to the company's audit committee (1) all significant deficiencies in the design or operation of internal controls that could adversely affect the issuer's ability to record, process, summarize, and report financial data and (2) any fraud, whether or not material, involving any employee who has a significant role in the issuer's internal controls.

15. Discuss the general requirements of Sections 404(a) and 404(b) of the Sarbanes-Oxley Act.

    Section 404 contains two subsections—404(a) and 404(b). 404(a) outlines management's responsibility under the act, and requires that the annual report include an internal control report by management that (1) acknowledges its responsibility for establishing and maintaining adequate internal control over financial reporting and (2) contains an assessment of the effectiveness of internal control over financial reporting as of the end of the most recent fiscal year. It also requires the principal executive and financial officers to make quarterly and annual certifications as to the effectiveness of the company's internal control over financial reporting. Section 404(b) outlines the independent auditor's responsibility. It requires the auditor to report on the internal control assessment made by management and also to make a separate independent assessment of the company's internal controls over financial reporting.

16. Discuss the framework for analysis that may be used in the resolution of ethical dilemmas.

    The resolution of ethical dilemmas can be assisted through a framework of analysis. The purpose of such frameworks is to help identify the ethical issues and to decide on an appropriate course of action. For example, the following six-step approach may be used:

    1. Obtain the relevant facts.
    2. Identify the ethical issues.
    3. Determine the individuals or groups affected by the dilemma.
    4. Identify the possible alternative solutions.
    5. Determine how the individuals or groups are affected by the alternative solutions.
    6. Decide on the appropriate action.

17. List the six criteria identified by the Anderson report and are indicative of effective auditor performance.

    The Anderson Report, indicated that effective performance should meet six criteria:\

    1. Safeguard the public's interest.
    2. Recognize the CPA's paramount role in the financial reporting process.
    3. Help ensure quality performance and eliminate substandard performance.
    4. Help ensure objectivity and integrity in public service.
    5. Enhance the CPA's prestige and credibility.
    6. Provide guidance as to proper conduct

18. List the four sections of the AICPA Code of Professional Conduct.

The Code of Professional Conduct in consists of the following four sections:

Principles. —the standards of ethical conduct stated in philosophical terms.
Rules of conduct. —minimum standards of ethical conduct.
Interpretations. —interpretations of the rules by the AICPA Division of Professional Ethics.
Ethical rulings. —published explanations and answers to questions about the rules submitted to the AICPA by practicing accountants and others interested in ethical requirements