**Chapter 6**

**Critical accounting policies**

**1. What are the advantages of having a former CFO as CEO?**

* CFOs tend to focus more on shareholder value creation and enhancement by considering all aspects of the business whereas CEOs with more marketing or operations backgrounds have the tendency to focus on growth and cost efficiency.
* CFOs pay close attention to metrics and focus on economic value-added activities and ways to improve performance and generate a return that exceeds the company’s cost of capital.
* CFOs may be regarded as investor-friendly because of their financial and market-analysis experience and attention to investor return on investment and stock price indicators.
* CFOs are better equipped to identify business risk associated with the company’s events and transactions and to assess the challenges and opportunities presented by the business risk.

**2. What are the basic components of executive compensation?**

* Salary.
* Annual incentive compensation.
* Long-term compensation.
* Stock option awards.
* Employment contracts, severance, and change of control payments.

**3. What does transparency in context to the quality of the financial report mean?**

Transparency means that companies provide all information needed by their shareholders to make decisions.

**4. What is an off–balance sheet transaction?**

An off–balance sheet transaction is any transaction or contract with an unconsolidated entity under which the company has:

* Any obligation associated with certain guarantee contracts.
* A retained or contingent interest in assets transferred to an unconsolidated entity.
* Any obligation including a contingent obligation under a material variable interest held in an unconsolidated entity.

**5. What are the two aspects of critical accounting policies and practices required as disclosures by the SEC’s *Strengthening the Commission’s Requirements Regarding Auditor Independence*?**

* Accounting estimates made by a company as part of its accounting policies including quantitative analysis of sensitivity to different assumptions.
* The initial adoption of an accounting policy that has a material effect on the presentation of financial statements.

**6. What is a non-GAAP financial measure?**

A numerical measure of a registrant’s historical or future financial performance, financial position, or cash flows that are included in the most directly comparable measure calculated and presented in accordance with GAAP.

**7. What are the steps taken by public companies and internal auditors to fulfill their internal control requirements?**

* Cooperation efforts between management and independent auditors in documenting ICFR while preserving auditor independence.
* Adoption of a suitable evaluation framework for ICFR (e.g. COSO framework).
* Effective oversight function of ICFR by the audit committee.
* Establishment of adequate disclosures for reporting on ICFR.

**8. What are the types of costs associated with Section 404 compliance?**

Two types of costs are associated with Section 404 compliance. The first category is the cost of compliance of Section 404, SEC implementation rules, and PCAOB auditing standards to bring internal control effectiveness in line with these requirements. These costs are viewed as one-time start-up costs that have been significant for companies with inadequate and ineffective internal control structure, causing them to spend substantial financial and human resources in designing, implementing, and operating the required internal controls. The second category of costs relates to the initial assessment, documentation, attestation, and reporting on compliance with both Sections 302 and 404. The second category consists of costs pertaining to ongoing, year-after-year, continuous monitoring of both the design and operation of internal controls and the continuous documentation, assessment, testing, and reporting requirements.

**9. Explain the steps involved in continuous process of improving the effectiveness of corporate internal control over financial reporting.**

* Remediation: ensures progress from “quick manual fixes” to building long-term sustainable solutions including an automated, streamlined continuous process.
* Sustainability: focuses on sustaining compliance in an ever-changing business and regulatory environment.
* Optimization: leverages knowledge and experience with Section 404 compliance to optimize other critical business processes.
* Integration: integrate Section 404 compliance process with other business processes to improve efficiency and effectiveness of operations and decision making.

**10. Explain the term enterprise risk management.**

A process, affected by an entity’s board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

**11. What are the four objectives of enterprise risk management?**

* Strategic.
* Operations.
* Reporting.
* Compliance.

**12. What are the major provisions of the Working Families Tax Relief Act (WFTRA)?**

* Tax brackets.
* Child tax credits.
* Alternative minimum tax.
* Qualified child.

**13. What are the characteristics of abusive tax shelters?**

* Lack of meaningful economic risk of loss or potential for gain.
* Inconsistent financial and accounting treatment.
* Presence of tax-indifferent parties.
* Complexity without a reasonable business purpose.
* Unnecessary steps or novel investments.
* Promotion or marketing of tax benefits as a central component.
* Confidentiality.
* High transaction costs.
* Risk reduction arrangements.

**14. What are the tax services provided for an audit client that can lead to an impairment of auditor independence?**

* Tax planning or advice involving potentially abusive tax transactions including listing transactions or confidential transactions under Treasury regulations.
* Tax services pertaining to planning or opinion on a transaction based on an aggressive interpretation of applicable tax rules, laws, and regulations.
* Tax compliance and planning services provided to the audit client’s senior officers who oversee the company’s financial reporting.

**15. What are the qualities of a CFO?**

* Strategic sense.
* Accounting expertise.
* Budgeting and planning ability.
* Management skill.
* Capital market knowledge.

**16. Explain the advantages of the having a CFO with CPA certification.**

* CPAs have a renewed commitment to the public interest and have worked diligently to develop public trust and investor confidence in financial reporting and their profession.
* They have a longer history of public trust and a well-deserved reputation for objectivity and honesty.
* They have valued continuing education and acquired new knowledge and skills to meet demands of the workplace and their profession.
* They are committed to a high level of professional competence and standards of ethical conduct and integrity.
* They are trusted professionals with the qualifications necessary to add value to corporate governance.

**Discussion Questions**

**1. Discuss the possible relationship between CEO performance and their compensation? Are they overpaid or underpaid?**

 Anecdotal evidence indicates that corporate executives are highly compensated regardless of their company’s performance, and even when they are forced out of their positions due to poor performance, they are still paid generously. Executive compensation is linked to short-term performance instead of long-term sustainable performance.

**2. “Executives should be given proper motivation and be paid for their good performance to create sufficient incentives for outstanding performance, and not be paid excessively for poor or underperformance.” Do you agree with this philosophy? Substantiate your answer.**

Executives should not be paid excessively for poor corporate performance, and proper incentives should be given to executives to lead the company in the right direction. Their compensation should be linked to the company’s sustainable performance in creating shareholder value.

**3. Explain the importance of the determination of CEO compensation reasonableness and its link to the company’s sustainable performance in the areas of economic, social, ethical, and environmental activities in general and creation of shareholder value in particular.**

The company’s board of directors and its representative, the compensation committee, should develop an effective, rewarding, and reasonable executive compensation program tailored to achieving the company’s mission and strategic goals, sustainable and enduring performance, and industry considerations. The contrasting views of investors and directors on reasonableness and relevance of executive pay suggest: (1) despite recent corporate governance reforms, management decides who gets on the board and thus directors have incentives to support pay arrangements that favor senior executives; (2) directors are more aligned with CEOs than with shareholders; and (3) outsized executive pay will continue to grow until shareholders are empowered to easily replace directors. The culmination of these contrasting views between investors and directors may result in further regulation and increased shareholder activism. Both of these reactions may have various economic, social, and ethical implications.

**4. What, according to you, should be done to face the consequences of the retirement of the baby-boom generation of financial executives?**

Answers may vary. Measures may be taken to ensure that the next generations of executives are competent and ethical in their duties. Educational and ethical programs within the company, review of corporate governance programs to promote their effectiveness, and appointing highly qualified individuals all would help to improve the competence and ethical awareness of the next generation of executives.

**5. Explain the role of management in the presentation of true financial statements in conformity with GAAP. Explain the advantages and disadvantages of incentives used by the management of any company.**

Management is primarily responsible for providing a true and fair presentation of financial statements in conformity with GAAP. In the post-SOX era, management certifies both internal control reports and financial statements, and is responsible and legally liable for inaccuracy or incompleteness of financial reports. Management may have incentive to manage earnings and when provided with the opportunity may engage in illegitimate and fraudulent earnings management schemes. Incentives for earnings management can be related to: (1) market incentives for meeting or exceeding analyst’s forecasts to prevent significant stock price declines following announcements that missed earnings estimates; (2) contractual incentives of maximizing managerial compensation or avoiding violation of debt covenants particularly when bonus plans and debt agreements are based on accounting information; (3) regulatory incentives of manipulated earnings to influence regulatory decisions (deflating earnings to avoid sanctions for potential antitrust violations); and (4) income smoothing incentives of reporting steadily increasing earnings to maximize stock prices particularly when executives are compensated through stock options.

**6. Explain how disclosure of financial statements can affect shareholders’ wealth.**

The disclosure of financial statements allows shareholders and other interested parties to obtain information regarding the financial position of the organization as of the report date. Shareholders may use this information to help make investment decisions regarding the organization and to obtain a better understanding of the industry in which the organization operates.

**7. Explain the importance of converging IFRS and GAAP.**

Convergence of IFRS and U.S. GAAP should benefit the global capital market primarily because such convergence reduces the differences in global accounting policies and practices. Convergence in financial reporting standards should benefit global investors and lenders when global consolidated financial statements are more comparable.

**8. Do you think enterprise risk management is gaining importance in today’s economy?**

Answers may vary. Enterprise risk management has recently received considerable attention and interest from public companies, the business community, and the accounting profession. Financial scandals of the early 2000s and recent world events including the September 11th terrorist attacks have generated more interest in the issue of overall ERM including traditional risks (e.g., strategic, financial, operational, information security, and reputational).

**9. What is meant by the term tax shelter? Can they help investors? Is it right on the part of the corporation to provide abusive tax shelters to corporations and individuals? Explain your point of view.**

Answers may vary. A tax shelter is a legal method of minimizing or decreasing taxable income and, therefore, tax liability. Tax shelters can range from investments or investment accounts that provide favorable tax treatment to activities or transactions that lower taxable income. Tax shelters not only have detrimental effects on tax collections, but the stock and the cost of debt prices can also be affected.

**True or False**

1. Financial statements should be prepared from the perspective of shareholders.

2. The relationship between CEO pay and their skills is positive and stronger when the firm does not have a large majority of shareholders.

3. The primary responsibility of the CFO is stewardship over the company’s finance.

4. The responsibility of CFOs is to ensure the effectiveness of internal control over financial reporting.

5. The establishment of and material amendments to the company’s long-term incentive plans require shareholder approval.

6. Stock option awards are classified as long-term incentive plans.

7. Section 404 of SOX requires the principal executive and financial officers of the company to certify each periodic report filed with the SEC.

8. SEC rules do not require public companies to disclose the aggregate of off–balance sheet arrangements in categories that increase understanding and discussion of important effects of the total arrangement.

9. Public companies are required to provide a qualitative and quantitative discussion in the financial statements of any material changes made to accounting estimates during the past three years.

10. SectionSS 302 of SOX authorizes the SEC to issue rules requiring public companies to make public disclosure on a “rapid and current basis” of their financial information.

11. SOX requires public companies to design and maintain adequate and effective internal controls.

12. The strategic objective of ERM is to obtain effective and efficient use of the entity’s resources.

13. Revenue recognition is one of the financial reporting challenges identified by Financial Executives International (FEI).

**True or False**

1. True

2. False

3. False

4. True

5. True

6. True

7. False

8. False

9. True

10. False

11. True

12. False

13. True

**Multiple Choice Questions**

**1. Corporations have a management team consisting of which of the following:**

1. CEO.
2. CFO.
3. Controller.
4. All of the above.

**2. Which of the following is/are responsible for promoting effective functioning, ethical conduct, and professional behavior throughout the company?**

1. CEO.
2. Management.
3. Board of directors.
4. All of the above.

**3. CEO pay is negatively related to skill when:**

1. There is no large shareholder to monitor management.
2. The CEO has been paid largely in options and stocks.
3. The firm has a large shareholder.
4. None of the above.

**4. Which of the following is/are special retirement arrangements made available to senior executives?**

1. Deferred compensation plans.
2. Supplemental retirement plans.
3. Retirement packages.
4. All of the above.

**5. Section 302 executive certification is signed by**:

1. CFO.
2. CEO.
3. Both the CEO and CFO.
4. Neither the CFO nor the CEO.

**6. According to Section 302, CFOs and CEOs are responsible for:**

1. Establishing and maintaining the company’s disclosure controls and procedures.
2. Assessing the effectiveness of the company’s disclosure controls.
3. Presenting in the MD&A their conclusions about the effectiveness of disclosure controls and procedures.
4. All of the above.

**7. Market incentives for meeting or exceeding analyst’s forecasts, contractual incentives of maximizing managerial compensation, and income smoothing incentives are all forms of:**

1. Earnings management incentives.
2. Stock price incentives.
3. Regulatory incentives.
4. Insider trading incentives.

**8. Incentives for earnings management can be related to which of the following:**

1. Regulatory incentives.
2. Market incentives.
3. Both (a) and (b).
4. Neither (a) nor (b).

**9. Which of the following is not a feature of a high-quality financial report?**

1. Relevance.
2. Usefulness.
3. Reliability.
4. Opaqueness.

**10. SOX directed the SEC to examine the last \_\_\_\_\_\_\_ of its accounting and auditing enforcement actions (AAEAs) to identify areas of financial reporting that are most susceptible to fraud, abuse, manipulation, and earnings management.**

1. 5 years.
2. 2 decades.
3. 10 years.
4. 4 years.

**11. SEC rules require public companies to disclose which of the following items about their off–balance sheet arrangements and their possible effects?**

1. The nature and purpose of the company’s off–balance sheet arrangements.
2. The relevance and importance of the identified off–balance sheet arrangements reasonably likely to result in a termination or material reduction.
3. The likelihood of any known event, demand, commitment, trend, or uncertainty.
4. All of the above.

**12. According to the SEC, accelerated filers are those public companies that have a public float of at least $75 million and have been subject to the SEC periodic reporting requirement for at least:**

1. 12 months.
2. 8 months.
3. 9 months.
4. None of the above.

**13. Which of the following SOX sections are considered directions to the SEC requiring the issuance of rules regarding conditions for the use of non-GAAP financial measures?**

1. Section 401.
2. Section 409.
3. Sections 401 and 409.
4. Neither Section 401 nor 409.

**14. Which of the following SOX sections require management and auditors to test and report on the effectiveness of internal controls?**

1. Section 404.
2. Section 302.
3. Section 401.
4. Section 409.

**15. The effectiveness of ERM depends on:**

1. The adequacy and effective functioning of its components.
2. Reporting and compliance.
3. The variety of electronic representational media available.
4. The assessed level of inherent risk of a corporation.

**16. COSO’s ERM framework is developed based all of the following except:**

1. Aligning risk appetite and strategy.
2. Enhancing risk response decisions.
3. Reducing operational surprises and losses.
4. Decreasing deployment of capital.

**17. All of the following are components of enterprise risk management identified by COSO except:**

1. Risk response.
2. Risk assessment.
3. Internal environment.
4. All of the above are components of enterprise risk management identified by COSO.

**18. Which of the following is not helpful in transparency of financial reporting?**

1. Working with the audit committee and management.
2. Providing assurance on financial information used by the company’s management.
3. Participating in the development of nonfinancial measures with other participants in the financial reporting process (e.g. customers, suppliers).
4. All of the above.

**Multiple Choice Questions**

1. d.

2. a.

3. a.

4. d.

5. c.

6. d.

7. a.

8. c.

9. d.

10. a.

11. d.

12. a.

13. c.

14. a.

15. a.

16. d.

17. d.

18. b.