Chapter 1

Review Questions

1. **What is the primary goal of corporate governance?**
   To create a balance of power-sharing among shareholders, directors, and management to enhance shareholder value and protect the interests of other stakeholders.
2. **What is the primary mission of a public company?**
   To create sustainable and enduring shareholder value.
3. **What is the role of a corporate governance gatekeeper?**
   To align management's interests with those of long-term shareholders and to protect investors from misleading financial information published in public filings.
4. **Corporate governance reforms and best practices require the establishment of what four key gatekeepers to deal with the perceived agency problems of asymmetric information between management and investors and to improve the quality of public financial information?**
   (1) Independent and competent board of directors; (2) independent and competent external auditor; (3) objective and competent legal counsel; and (4) objective and competent financial advisors and investment bankers.
5. **How does an effective corporate governance structure improve investor confidence?**
   It ensures corporate accountability, enhances the reliability and quality of public financial information, and enhances the integrity and efficiency of the capital market.
6. **What is the primary intent of corporate governance reforms?**
   To improve:
   - The reliability, integrity, transparency, and quality of financial reports.
   - The effectiveness of internal controls over financial reporting and related risk management assessment.
   - The credibility of the external audit function.
   - The independence and objectivity of other gatekeepers such as legal counsel and financial analysts.
   - Shareholder monitoring and democracy.
7. **What benefits are obtained by the proper implementation of SOX?**
   - Improved corporate governance.
   - Enhanced quality, reliability, and transparency of financial information.
   - Improved audit objectivity and effectiveness in lending credibility to published financial statements.
8. **How can the board of directors influence the corporate culture?**
   - Set an appropriate "tone at the top," promoting personal integrity and professional accountability.
   - Reward high-quality and ethical performance.
   - Discipline poor performance and unethical behavior.
   - Maintain the company's high reputation and stature in the industry and the business community.

9. What is the intention of organizational codes of business ethics and conduct?

Codes of business ethics and conduct are intended to govern behavior, but they cannot substitute for moral principles, culture, and character.

10. Corporate governance depends on what three practices to be effective?

- Compliance with state and federal statutes.
- Compliance with listing standards.
- Implementation of best practices suggested by investor activists and professional organizations.

11. Why is there no universal definition of corporate governance?

The scope covers a vast array of distinct economic phenomena and it is often described from a shareholder's view.

12. How have SOX provisions, SEC-related rules, and listing standards influenced the corporate governance structure?

- Auditors, analysts, and legal counsel who were not traditionally considered components of corporate governance are now brought into the realm of internal governance as gatekeepers.
- The legal status and fiduciary duty of company directors and officers have been more clearly defined and significantly enhanced.
- Certain aspects of state corporate law were preempted and federalized.

13. What business entities are currently affected by SOX?

SOX applies equally to and is intended to benefit all publicly traded companies, although many provisions are also relevant to private and not-for-profit organizations.

14. What is the difference between a shareholder and a stakeholder?

Shareholders are individuals or groups who are traditionally the primary users of the company's financial reports, which reflect the company's financial condition and the results of operations. They also have greater rights of involvement with decisions and monitoring of a company. Stakeholders are individuals or groups, including shareholders, creditors, customers, employees, suppliers, competitors, governmental entities, environmental agencies, and social activists, who affect the company's strategic decisions, operations, and performance.

15. What are the primary differences between financial reporting and corporate accountability reporting?

Financial Reporting	Corporate Accountability Reporting
• Legal requirement.	• Not a legal requirement.
• Prepared based on a set of generally accepted accounting principles and standards.	• No single set of standards which are widely agreed upon.
• Audit is required.	• No mandatory assurance report.
• Guidelines specify the type and level of assurance.	• No guidelines specify the type and level of assurance.
• Prepared primarily for shareholders.	• Provided to a broad range of stakeholders with different and often competing interests.

16. What is the relationship between corporations and stakeholders, and what is the corporations' role in that relationship?

There is a contractual relationship between corporations and their stakeholders. The corporations' role is to create and protect the value of that contract.

17. What is the primary difference between the first and second tier of the stakeholder hierarchy?

The first tier is the shareholders and owners of the corporation. They are absent in the daily operations. The second tier consists of those involved in the operations of the corporations.

19. To whom are corporations accountable?

Corporations are accountable to all internal and external stakeholders in a corporation. This can lead however to agency problems.

19. Explain the relationship between corporations and the capital markets in the United States.

The capital markets provide funds to corporations and thus monitor their corporate governance to align the interests of management with the interests of investors. On the other hand, corporations provide relevant financial information to the capital markets, which facilitates the efficiency and liquidity of the capital markets.

Discussion Questions

1. **In your own words, briefly explain the concepts of value creation and value protection.**

   The value creation goal of corporate governance focuses on shareholder value creation and enhancement through the development of long-term strategies to ensure sustainable and enduring operational performance. The value protection goal of corporate governance concentrates on the accountability of the way a company is managed and monitored to protect the interests of shareholders and other stakeholders. These two concepts should be considered within every company.

2. **Has Sarbanes-Oxley thus far had a positive, negative, or neutral effect on public companies? Defend your answer.**

   The Sarbanes-Oxley Act has had an overall positive effect on public companies. Within the areas of financial reporting and corporate accountability, SOX has encouraged management to effectively formulate and implement a strong system of internal control and financial reporting such that errors and fraud are materially prevented, detected, and corrected. SOX has increased the cost of compliance with federal regulations, particularly with Section 404, but these costs are outweighed by the benefits of robust financial reporting, increased scrutiny of management's dealings within the organization, and increased investor confidence. Additionally, measures are being taken to decrease the costs of SOX, such as proposed Auditing Standard No. 5 by the PCAOB.

3. **Discuss the following quote from Lori A. Richards, the SEC's Director of the Office of Compliance Inspections and Examinations:**

   > **"It's not enough to have policies. It's not enough to have procedures. It's not enough to have good intentions. All of these can help. But to**

be successful, compliance must be an embedded part of your firm's culture."

In addition to policies and procedures designed to promote effective corporate governance, organizations must create and reinforce a consistent, positive corporate culture which complements such measures. Members of the organization, starting with the executives, must lead by example in their efforts to encourage others to comply with applicable policies and procedures. The norms and values embraced by the organization as its corporate culture should be consistent with its policies and procedures; otherwise behavior inconsistent with those policies and procedures will result. Compliance just for the sake of compliance and the development of a "check box" mentality is not enough. Corporations should create an ethical culture that encourages all corporate governance participants including directors, officers, auditors, financial advisors, employees, and others to do the right thing and understand that this is vital to the company's sustainable financial performance.

4. **What are the benefits of an MBL approach?**

   MBL reporting forces organizations to consider the effects of many aspects of their operations in addition to financial reporting, such as environmental, social, ethical, and governance performance. Since the effects of organizations in these areas can be significant, many stakeholders benefit from the fact that MBL reporting makes organizations accountable for the effects of their operations in many different areas.

5. **Who are first-tier, second-tier, and third-tier stakeholders, and why are they significant to the organization?**

   The first tier of stakeholder hierarchy consists of investors or shareholders who own the company. Shareholders are the primary stakeholders—without them the company would not exist. Many argue that the primary purpose and responsibility of the company is to maximize shareholder wealth by creating sustainable and enduring shareholder value. Thus, the company's corporate governance structure should reduce the agency costs raised from the separation of ownership and control by aligning the interests of management with those of the shareholders. Lenders and creditors are considered as the second-tier stakeholders in the company. Debtholders may have significant power in situations in which the organization is funded largely by debt. The third tier of stakeholders consists of employees, suppliers, governments, customers, and society. This tier should be important to the organization, as the collective actions of such a large base of stakeholders could significantly affect the organization.

6. **What is the significance of quality financial statements and other financial reporting information?**

Financial statements are a vital source of information to the capital markets and their participants. The quality of investment and voting decisions by investors depends on the accuracy, completeness, and reliability of financial information disseminated to them by public companies. Thus, high-quality financial information improves investor decisions and in turn the efficiency, liquidity, and safety of the capital markets, which may result in prosperity and economic growth for the nation. Therefore, quality financial statements and other financial reporting information is important to the strength of capital markets.

7. **What are the responsibilities of corporate governance gatekeepers?**

   The board of directors is charged with overseeing management's strategy and performance. The external auditor is responsible for providing a high level of assurance regarding the reliability, quality, and transparency of the financial reports of public companies. Legal counsel is charged with providing legal advice and ensuring more than mere technical compliance with applicable laws, regulations, rules, and standards. The financial advisors and investment bankers are responsible for advising company management and the board in conducting legitimate business affairs and transactions that have a valid economic purpose. All gatekeepers must be competent in order to be effective in promoting strong corporate governance.

8. **What should the board of directors do to promote a positive corporate culture?**

   The engaged board of directors can significantly influence the corporate culture by: (1) setting an appropriate "tone at the top," promoting personal integrity and professional accountability; (2) rewarding high-quality and ethical performance; (3) disciplining poor performance and unethical behavior; and (4) maintaining the company's high reputation and stature in the industry and the business community. By taking these actions, the board of directors helps to promote a culture within the organization that is consistent with corporate governance objectives.

9. **Will compliance with applicable laws, rules, and regulations ensure effective corporate governance? Explain your answer.**

   Mere compliance with applicable laws, rules, and regulations will not guarantee effective corporate governance, since those measures cannot change the culture within an organization. Thus, companies should integrate the best practices suggested by investor activists and professional organizations into their corporate governance structure. Effective corporate governance can only be achieved when all participants: (1) add value to the company's sustainable long-term performance; (2) effectively carry out their fiduciary duty and professional responsibilities; (3) are held accountable and personally responsible for their performance; and (4) develop a practice of not only complying with applicable regulations, but also committing to doing the right thing, observing ethical principles of professional conduct in avoiding potential conflicts of interest, and acting in the best interests of the company and its shareholders.

10. **What are some reasons for integrating corporate governance and business ethics education into the business curriculum?**

    The following are reasons for integrating corporate governance and business education into the business curriculum: (1) reported financial scandals (e.g., Enron, WorldCom, Global Crossing, Adelphia, Qwest) underscore the importance of vigilant corporate governance and ethical conduct by corporations; (2) the Sarbanes-Oxley Act of 2002 (SOX) is intended to improve corporate governance by enforcing more accountability for public companies and requiring adoption of a code of ethics for their executives; (3) anecdotal evidence and academic studies suggest that corporate governance and business ethics are not properly integrated into business education, and coverage of these issues should be increased; (4) teaching and research in corporate governance and business ethics have been strongly recommended and encouraged; (5) there is an inventory of support materials for teaching business ethics and corporate governance in the post-Enron era. There are sufficient resources (textbooks such as this book, published articles, Internet Web sites, videos) to offer a stand-alone course or integrate business ethics and corporate governance modules throughout accounting courses; (6) it is easier to obtain administrative support to offer business ethics and corporate governance courses in the post-SOX era; (7) several business schools have developed innovative strategies for engaging students in the challenge of providing ethical leadership by focusing on both positive and negative examples of everyday conduct in business; (8) there is an increasing trend toward incorporation of business ethics and corporate governance education into the business curriculum worldwide; (9) accounting programs should integrate provisions of SOX on corporate governance, financial reporting, and audit functions into the curriculum; (10) corporate governance has evolved from compliance requirements to a business imperative; (11) the National Association of State Boards of Accounting (NASBA), in its Exposure Draft of Uniform Accounting Rules 5-1 and 5-2 regarding NASBA 150-hour education, emphasized the need for six semester credit hours in ethical and professional responsibilities; and (12) the Association to Advance Collegiate Schools of Business International (AACSB) has promoted the integration of business ethics and corporate governance into the business curriculum.

11. As noted in the text, corporate governance has no universally accepted definition. Define corporate governance and explain your definition.

Within a dispersed ownership structure, corporate governance is a process affected by legal, regulatory, contractual, and market-based mechanisms and best practices to create substantial shareholder value while protecting the interests of other shareholders. In a capital structure where there is a concentrated ownership and a small group of shareholders can exercise ownership control, corporate governance should ensure alignment of the interests of controlling shareholders with those of minority or individual shareholders.

12. **The following is a list of eight entities and conventional systems that shape corporate governance. Provide examples of how or what they have done.**

a. **Federal legislation**

Rules and regulations set forth by Congress provide guidance as to the operation of corporate governance in publicly traded companies. An example would be the Sarbanes-Oxley Act of 2002, which dramatically affected corporate governance guidelines both in the United States and around the world.

b. **State statutes**
   State statutes affect the way public organizations execute corporate governance within a particular state. In conjunction with federal guidelines, state statutes can provide additional guidance on corporate governance through corporate charters.
c. **SEC regulation**
   The SEC rules and regulations provide guidance for publicly traded companies in corporate governance. The SEC, in conjunction with the Public Company Accounting Oversight Board (PCAOB), provides these guidelines to increase the effectiveness of corporate governance.
d. **The courts**
   The courts may at times set legal precedents through the interpretation of those rules and regulations set forth by Congress, the SEC, and the PCAOB. These courts, in effect, give publicly traded companies guidance on how to adhere to corporate governance rules and regulations.
e. **Listing standards**
   Listing standards of national stock exchanges also provide guidance on corporate governance for organizations attempting to list on those exchanges. Often, an organization must adhere to certain corporate governance guidelines set forth by the stock exchange before the organization would be eligible to list on that exchange.
f. **Investor activists**
   Investor activists fight for investor rights and serve as watchdogs to ensure that organizations are protecting those rights. Investor activists may push certain corporate governance practices in order to increase the quality of corporate governance within an organization.
g. **Investors**
   Investors, like investor activists, may aid in monitoring the operations of a company. And similar to investor activists, investors may push certain corporate governance practices in order to increase the quality of corporate governance within an organization.
h. **Other corporate governance participants**
   Other corporate governance participants, such as corporate governance gatekeepers, may aid in monitoring the corporate governance practices within an organization. These participants may aid the others in influencing many aspects of corporate governance within different organizational settings.

13. **The book mentions many examples of the give-take relationship between corporations and society. What are some other examples of the corporation/society relationship? Provide a minimum of three examples.**
    One example of this relationship could be found in a manufacturing plant environment in which the manufacturing process is such that hazardous emissions are released into the atmosphere. The corporation is able to supply jobs for those in the area, but they may have to live close to the plant and be subject to harmful emissions. Another example can be found in the pricing policy of many corporations. Corporations may need to price a certain product high enough to cover costs, but this price may make the product unavailable to those who need it most. Should the corporation decrease its price, it could become insolvent. Should

it maintain its price, those who need the product most may have to do without it. Yet another example of the give-take relationship between corporations and society is the compensation policy of management within an organization. Such compensation should be high enough to attract highly qualified individuals, but should not be so exorbitant that it becomes a detriment to the shareholders of the organization.

14. **Discuss the significance and importance of investors (shareholders) as the first tier of the stakeholder hierarchy.**

    Shareholders are the primary stakeholders; without them the company would not exist. Many argue that the primary purpose of the company is to maximize shareholder wealth. Thus, the company's corporate governance structure should reduce the agency costs raised from the separation of ownership and control by aligning the interests of management with those of shareholders. Shareholders provide capital to the company in return for sustainable return on their investment in terms of periodic dividends and stock price appreciations. Payment of dividends reduces the amount of discretionary funds available to management and, thus, can be used as a deterrent to opportunistic managerial behavior and as a vehicle for controlling management actions. Shareholders participate and shape the company's corporate governance structure by exercising their voting rights to elect the members of the board of directors who are directly responsible to protect their interests and are ultimately accountable to them for the company's business affairs.

True/False

1. Investors are taking a more active role in their financial future through private investments in the securities markets.
2. The involvement of the board of directors, audit committee, management, and auditors is considered a value-adding function.
3. Investors should not and do not rely on financial reports for decision making purposes.
4. The board of directors is elected by shareholders and is responsible for hiring the appropriate management to operate the daily company operations.
5. Recent accounting scandals helped to boost the public's confidence and trust in financial disclosures presented in financial reports.
6. A corporate gatekeeper is assigned to ensure that only authorized individuals are allowed in the corporate offices.
7. Companies with a well-defined corporate governance structure are more likely to restate their earnings than companies with no corporate governance structure.
8. Corporate governance has one worldwide accepted definition, "To promote corporate fairness, transparency, and accountability."
9. Market correction mechanisms are preventive measures initiated prior to abuse and loss.
10. Corporate governance regulations will continue to be a leading discussion among policy makers, stakeholders, and corporate activists even as changes are made.
11. Sarbanes-Oxley applies to both public and private companies with annual revenues $10 million or greater.

12. Integrity in the equity market and restored investor confidence are both primary purposes of the Sarbanes-Oxley Act.
13. Compliance is compliance and a company does not need to establish a compliant culture from the top down.
14. Financial markets play an important role in creating safe, efficient, and the most competitive capital markets to ensure economic growth, low costs of capital, entrepreneurship, innovation, and job creation.
15. The preservation of the integrity, reputation, and efficiency of the capital markets is not the responsibility of all capital market participants.
16. The free enterprise system in the United States is characterized by a dispersed capital ownership structure.
17. Recent reported financial scandals prove that market mechanisms by themselves may not be adequate to monitor, control, and discipline business affairs, and corporate governance reforms are needed to correct the perceived failures of market mechanisms.
18. The improvement in public trust and investor confidence in corporate America, its financial reports, and capital markets is of no concern or priority to public companies.
19. Shareholders who invest capital in U.S. companies are often close by distance or knowledge to those managing corporations.
20. Corporations in the United States are viewed as creators of value for all concerned stakeholders.
21. All stakeholders are provided with incentives and opportunities to reward corporations for good performance and discipline them for poor performance.
22. The first tier of stakeholder hierarchy is investors or shareholders who own the company.
23. The extent to which an organization derives its funding from equity or debt does not significantly affect the business decisions of the company.
24. The sustainability and financial health of public companies, public trust, and investor confidence in financial reports play a crucial role in the integrity and efficiency of the capital markets and the economic growth and prosperity of the nation.
25. Reliability, accuracy, and transparency of financial information do not play a vital role in the efficiency, integrity, and safety of the capital markets.
26. The primary role of all corporate governance participants, as defined in this book, should center around the fundamental theme of protecting shareholders, restoring investor confidence, and supporting strong and efficient capital markets.
27. A compliance culture requires the establishment and implementation of proper programs, policies, and procedures to effectively comply with applicable regulations, laws, rules, standards, and best practices.
28. Companies that are well governed will usually outperform poorly governed companies and will be able to attract investors to help finance further growth.
29. Shareholders are a type of stakeholder.
30. The board of directors is held personally liable for all damages caused by decisions that resulted in unsuccessful conclusions.
31. Corporations in the United States are viewed as destroyers of value for all concerned stakeholders.

32. The relationship between corporations and society is contractual and is demonstrated by a give/take scenario.

True/False

1. True
2. True
3. False
4. True
5. False
6. False
7. False
8. False
9. False
10. True
11. False
12. True
13. False
14. True
15. False
16. True
17. True
18. False
19. False
20. True
21. True
22. True
23. False
24. True
25. False
26. True
27. True
28. True
29. True
30. False
31. False
32. True

Multiple Choice

1. **Which of the following is not crucial to the integrity and efficiency of capital markets and economic growth?**
   a. Sustainability and financial health of public companies.
   b. Public trust.
   c. High stock prices.
   d. Investor confidence.
2. **Investors should rely on which of the following to make rational, informed**

investment decisions?

a. Accurate financial statements and reports.
b. Former employees.
c. Internet "blogs" and message boards.
d. Insider information.

3. **PCAOB stands for:**
   a. Popular Company Accounting Oversight Board.
   b. Public Company Accounting Oversight Board.
   c. Public Company Accounting Oversight Bulletin.
   d. Popular Company Accounting Oversight Bulletin.
4. **Conflicts of interest among corporate governance participants are referred to as an:**
   a. "Anything you can do, I can do better" problem.
   b. Alignment problem.
   c. Agency problem.
   d. There are no conflicts of interest among corporate governance participants.
5. **The primary mission of a public company is to:**
   a. Make money now without planning for the future.
   b. Keep management happy.
   c. Create sustainable and enduring corporate value.
   d. Remain idle and complacent with current performance.
6. **Public companies are required to comply with all of the following *except*:**
   a. Federal and state laws and regulations.
   b. Listing standards of their respective exchange.
   c. Best practices of leading competitors.
   d. All of the above require compliance.
7. **Which of the following would be an example of a corporate gatekeeper?**
   a. Independent and competent board of directors.
   b. Independent and competent external auditor.
   c. Objective and competent legal counsel or financial advisor.
   d. All of the above would be an example of a corporate gatekeeper.
8. **The improvement of corporate governance and financial reporting by SOX should add the following benefits *except*:**
   a. Improved investor confidence.
   b. Increased firm value.
   c. Decreased cost of capital.
   d. Increased audit fees.
9. **The Federal Sentencing Guidelines require:**
   a. Swift and harsh penalties.
   b. Compliance and ethics training.
   c. Companies to eliminate incentives for ethical performance.
   d. Martha Stewart treatment for all financial statement frauds.
10. **The elements of a multiple bottom line (MBL) approach are economic, social, ethical, and:**
    a. Equity.
    b. Environmental.

c. Eccentricity.
d. None of the above.

11. A compliance culture can be promoted through the establishment of a centralized:

a. Chief executive officer.
b. Chief governance officer.
c. Chief compliance officer.
d. Board of directors.

12. Multiple-bottom-lines focus on:

a. Improving internal control over financial reporting.
b. Enhancing organizational disclosures concerned with social, environmental, and ethical issues.
c. Creating and sustaining effective corporate structure.
d. Reporting on the many ventures in which the organization is involved.

13. Congress passed the Sarbanes-Oxley Act of 2002 to:

a. Enhance the burden of financial reporting.
b. Establish a new regime of investor protection.
c. Increase the workload of auditors of public companies.
d. Provide more protection to the managers of public companies.

14. Which of the following does not effectively characterize the post-SOX era:

a. A change in the regulatory framework for the auditing profession through the establishment of the PCAOB.
b. The move toward more transparent and timely financial reports.
c. A redefining of roles and responsibilities of those who are directly or indirectly involved in the financial reporting process.
d. The reduction of the importance and role of ethics within publicly traded companies.

15. Suppliers and customers reward good corporate performance by:

a. Actively and favorably doing business with the company.
b. Investing in the company at the lower desired rate of return of investment.
c. Disinvesting or demanding a higher rate of return on their investment.
d. Giving extra benefits to the management of the company.

16. The primary mission of public companies is regarded as:

a. Reporting increasing revenues.
b. Decreasing unemployment rates.
c. Creating sustainable and enduring value.
d. Decreasing costs.

17. The primary stakeholders are:

a. Customers.
b. Suppliers.
c. Shareholders.
d. Creditors.

18. Shareholders own corporations and the ______________ is elected to make business decisions on behalf of shareholders.

a. Chief executive officer.
b. Board of directors.

c. Chief compliance officer.
d. Legal counsel.

19. Which of the following are considered to be the second-tier stakeholders in the company?

a. Lenders and creditors.
b. Customers and suppliers.
c. Shareholders.
d. Governmental oversight bodies (e.g., PCAOB, SEC).

20. Which of the following are not considered third-tier stakeholders?

a. Employees.
b. Customers.
c. Suppliers.
d. Creditors.

21. Which of the following is not a key corporate gatekeeper?

a. Board of directors.
b. External auditor.
c. Governmental oversight bodies (e.g., PCAOB, SEC).
d. Legal counsel.

22. Gatekeepers should:

a. Be employees of the company and use their internal insight to effectively monitor corporate governance practices.
b. Accept the representations of management on full faith.
c. Be fully independent from the company.
d. Fulfill their professional responsibility to the management of the company.

23. Effective corporate governance does all of the following except:

a. Ensure corporate accountability.
b. Enhance the integrity and efficiency of the capital market.
c. Eliminate the prospect of fraud within an organization.
d. Enhance the reliability and quality of public financial information.

24. With the ___________ the primary goal is to achieve economic performance, while proper consideration is given to other measures including social, ethical, and environmental (SEE) issues.

a. Multiple bottom lines (MBL) objectives.
b. PCAOB Auditing Standards.
c. SEC Final Statements.
d. Generally Accepted Accounting Principles (GAAP).

25. The goal of corporate governance and business ethics education is to:

a. Teach students their professional accountability and to uphold their personal integrity to society.
b. Change the way in which ethics is taught to students.
c. Create more ethics standards by which corporate professionals must operate.
d. Increase the workload for accounting students.

26. The relationship between public companies and shareholders, creditors, auditors, etc. is:

a. Marital.
b. Contractual.

c. Legally nonbinding.
d. There is no relationship.

27. An advantage of a corporation is:

a. Limited liability for the owners.
b. Unlimited life of the corporation.
c. Ease of transferability of ownership interests.
d. All are advantages of a corporation.

28. The second tier of the stakeholder hierarchy consists of all of the following except:

a. Creditors.
b. Employees.
c. Shareholders.
d. Suppliers.

29. GAAP stands for:

a. Generally Accepted Accounting Procedures.
b. Generally Abnormal Accounting Procedures.
c. Generally Accepted Accounting Principles.
d. Generally Abnormal Accounting Principles.

30. The ultimate responsibility for maintaining an appropriate balance between management and the owners rests with:

a. Board of directors.
b. Managers.
c. Shareholders.
d. Regulating entities.

Multiple Choice

1. c.
2. a.
3. b.
4. c.
5. c.
6. c.
7. d.
8. d.
9. b.
10. b.
11. c.
12. b.
13. b.
14. d.
15. a.
16. c.
17. c.
18. b.
19. a.
20. d.

21. c.
22. c.
23. c.
24. a.
25. a.
26. b.
27. d.
28. c.
29. c.
30. a.

Chapter 2

Review Questions

1. **What are the three "legs" of the corporate governance structure discussed in Chapter 2?**
   Corporate governance aspects, corporate governance principles, and corporate governance functions.
2. **What is the underlying focus of the shareholder aspect of corporate governance?**
   Value creation for the shareholder through corporate governance effectiveness.
3. **What types of managerial failures prevent management from acting in the best interest of the shareholders?**
   - Failure of managerial competence resulting from unintentional mistakes or negligence in discharging fiduciary duties.
   - Failures of managerial integrity caused by willful or opportunistic behaviors (fraudulent activities, fabrications, embezzlement, illegitimate earnings management) that have detrimental effects on the value of the firm's assets.
4. **Value protection is the goal of which corporate governance aspect?**
   Stakeholder corporate governance aspect.
5. **What is corporate governance resilience and how is it maintained?**
   Corporate governance resilience is the ability of a corporation to sustain and recuperate from setbacks and abuses. It is maintained through the internal and external mechanisms that the corporate governance structure of a company implements to prevent, detect, and correct such setbacks and abuses.
6. **What is corporate governance responsiveness?**
   Corporate governance responsiveness is the company's timely and appropriate response to the concerns, requests, or desires of investors, customers, employees, auditors, suppliers, social responsibility activists, and other stakeholders.
7. **Explain corporate governance transparency.**
   Transparency is the notion that a company is openly and coherently disclosing to the public relevant corporate information.
8. **What are the seven essential corporate governance functions?**
   The seven essential corporate governance functions are oversight, managerial, compliance, internal audit, advisory, external audit, and monitoring.
9. **What are the roles and responsibilities of inside and outside directors?**
   Inside directors usually provide executive services considered to be important in

improving the company's financial performance, whereas outside directors provide monitoring services, which are also important in aligning management's interests with those of shareholders.

10. What items are likely to be recorded in a corporate governance report?

Corporate governance reporting ideally would include:

- The company's vision, strategies, and missions in creating stakeholder value.
- The board of director's composition, independence, involvements, functions, and evaluation.
- Financial, economic, social, and environmental indicators.

11. What is the basic cause of corporate agency problems?

The separation of control and ownership is the basic cause of corporate agency problems.

Discussion Questions

1. What are the versions of corporate governance mechanisms? How are they effective? How can they be ineffective?

Internal and external corporate governance mechanisms exist to aid and improve corporate governance. Internal mechanisms are designed to manage, direct, and monitor corporate activities in order to create sustainable and enduring stakeholder value. Examples of internal governance mechanisms are the board of directors, particularly independent directors, the audit committee, management, internal controls, and internal audit functions. External governance mechanisms are intended to monitor the company's activities, affairs, and performance to ensure that the interests of insiders (management, directors, and officers) are aligned with the interests of outsiders (shareholders and other stakeholders). Examples of external mechanisms are the capital market, the market for corporate control, and the labor market, as well as state and federal statutes, court decisions, shareholder proposals, and best practices of investor activists. These mechanisms may be helpful in aligning management incentives with shareholder interests, and also controlling management behavior. Corporate governance mechanisms may be ineffective in situations in which independence is removed, or in which corporate governance participants fail to perform their duties.

2. Identify and define the three aspects of corporate governance.

The shareholder aspect of corporate governance is the concept that the corporation exists for the benefit of shareholders, and therefore, emphasizes shareholder value creation and enhancement as the primary objective of corporations. The shareholder aspect of corporate governance is based on the premise that shareholders provide capital to the corporation which exists for their benefit. It supports the agency theory that fiduciary duties of corporate directors and executives are to shareholders who have a residual claim on the company's residual assets and cash flows. Shareholders (principals) provide capital to the company, which is run by management (agent). The principal-agent problem exists because corporations are separate entities from their owners—management needs physical capital (investment funds) and investors need skilled human capital to run the company. The stakeholder aspect of corporate governance is the premise that a company's success depends on the contributions of investors and other key groups and how well it manages the relationships with those groups which consist of shareholders, creditors, employees, supplies, customers, and communities. The stakeholder model of corporate governance focuses on a broader view of the company as a nexus of contracts among all corporate governance participants with the common goal of creating value. The emerging model concentrates on maximization for all stakeholders, including: (1) contractual participants such as shareholders, creditors, suppliers, customers, and employees; and (2) social constituents including the local community; society and global partners; local, state, and federal governments; and environmental matters. Under this view, public companies must be socially responsible—good citizens granted the use of the nation's physical and human capital, managed in the public interest. The integrated aspect of corporate governance focuses on both shareholder value creation and enhancement and stakeholder value protection. Modern corporate governance emphasizes both financial aspects of increasing shareholder value and an integrated approach that considers the rights and interests of all stakeholders. Corporate governance should be viewed as a dynamic and integrated approach of addressing financial, social, environmental, and economic concerns of all stakeholders.

3. **What entities or groups of individuals are responsible for the oversight, managerial, and monitoring functions, and what are their basic responsibilities and duties?**

   The oversight function is the responsibility of the board of directors, which is charged with the fiduciary duty of overseeing the managerial function in the best interests of the company and its shareholders. The managerial function is the responsibility of management, which is charged with the responsibility of running the company and managing its resources, operations, and disclosures of relevant and reliable financial and nonfinancial information. The monitoring function is the responsibility of shareholders, particularly institutional shareholders, who are empowered to elect and, if warranted, remove directors. Shareholders can influence corporate governance through their proposals and nominations to the board of directors. Shareholders elect directors, and directors appoint officers to manage the company. Other stakeholders such as creditors, employees, financial analysts, and investor activists can also affect corporate policies and practices.

4. **Compare and contrast the internal and external audit functions.**

   The internal audit function provides both assurance and consulting services to the company in the areas of operational efficiency, risk management, internal controls, financial reporting, and governance processes. The external audit function is performed by external auditors in expressing an opinion that financial statements truly and fairly represent, in all material respects, the company's financial position and the results of operations in conformity with GAAP. External auditors lend credibility to the company's financial reports and thus add value to its corporate governance through their integrated audit of both internal control over financial reporting and financial statements. Both parties provide assurance and both may aid in the audit of financial statements. However, external auditors are independent and work to provide assurance to shareholders, while internal auditors are not independent, and work to provide assurance to management.

5. **The text notes that corporate governance reforms have reduced many potential conflicts of interest among corporate governance participants including directors, management, auditors, financial analysts, corporate counsel, and investors. What conflicts of interest are possible among these groups?**
   Conflicts of interests may arise among directors, management, auditors, financial analysts, corporate counsel, and investors in instances in which personal goals of such participants are at odds with those of others. For example, conflicts of interest may arise among management and shareholders or the board of directors as to the operation of the organization. Also, management may experience conflict with corporate gatekeepers acting on behalf of the shareholders, such as auditors, corporate counsel, and the board of directors.
6. **As an investor, would you find use in corporate governance reports? Explain.**
   Corporate governance reporting reports the effectiveness, responsiveness, and credibility of an organization's corporate governance measures. Corporate governance measures and performance indicators that could be included in CGR are: (1) descriptions of an organization's culture, appropriate tone at the top, board of directors, internal controls, and commitment to economic, social, and environmental goals; (2) major risks facing the organization in achieving its economic, social, and environmental goals and measures taken to address such risks; (3) the percentage of the board of directors who are independent and nonexecutive directors; (4) the existence of an audit committee comprising all independent and financially literate directors; (5) the adequacy of internal controls; (6) corporate governance principles and mechanisms to which the organization adheres; and (7) the status of the organization's compliance with applicable laws, rules, regulations, and standards, and disclosure of areas of noncompliance. All of these reported phenomena would be helpful in assessing the future viability of the organization.
7. **Use your research skills to search the Internet for information regarding the most recent GMI ratings. Do the ratings show an improvement in corporate governance procedures? Briefly comment on your findings.**
   Information on recent GMI ratings may be found at www.gmiratings.com or via the use of a popular Internet search engine.
8. **Many "best practices" are mentioned in the text. Which three best practices do you agree with and which three best practices do you disagree with? Explain.**
   Answers will vary. Corporate governance best practices suggested by professional organizations and investor activists are nonbinding corporate governance guidelines intended to improve corporate governance policies and practices of public companies above and beyond state and federal statutes and listing standards.
9. **In your own words, what is honesty?**
   Answers will vary. Honesty means telling the truth at all times, regardless of the consequences. Honesty is important in establishing a trusting relationship among all corporate governance participants. This also means that corporate communications with both internal and external audiences, including public financial reports, should be accurate, fair, transparent, and trustworthy. A

reputation for honesty can be earned over time through truthful and transparent corporate communication, and it can be easily destroyed through lies, deceptions, malfeasance, concealments, and fraud.

10. Hypothetically, what are the agency problems that exist in your work and school environment?

Answers will vary. Possible agency problems may arise between corporate governance participants with differing goals and objectives. Agency problems within a school may arise from differing goals and objectives between those funding the school and those actually running the day-to-day operations in the school.

11. Perform an Internet search for the Securities Acts of 1933 and the Securities Exchange Act of 1934. What are some of the key provisions of these acts?

Internet information on these acts of legislation may be found at sec.gov/about/laws.shtml. These Acts are primarily disclosure-based statutes that require public companies to file a periodic report with the SEC and disclose certain information to their shareholders to make investment and voting decisions.

12. Are internal or external corporate governance mechanisms more influential to the effectiveness of corporate governance? Defend your answer.

A proper balance between internal and external corporate governance mechanisms must be present in order to ensure the effectiveness or corporate governance. Internal mechanisms are designed to manage, direct, and monitor corporate activities in order to create sustainable and enduring stakeholder value. Without proper internal mechanisms, lack of vigilance by the board of directors may result. External governance mechanisms are intended to monitor the company's activities, affairs, and performance to ensure that the interests of insiders (management, directors, and officers) are aligned with the interests of outsiders (shareholders and other stakeholders). Without proper external mechanisms, investors may not be adequately protected.

13. Which approach do you prefer: principles-based or rules-based? Why?

Answers will vary. The principles-based approach emphasizes operating within the "spirit of the law," whereas the rules-based approach emphasizes abiding by the "letter of the law." The rules-based approach may be useful in promoting uniformity and clarity in the application of regulations pertaining to corporate governance, but may be inconclusive in some areas and allow subjects to deviate from the principle of the law without violating the letter of the law. The principles-based approach promotes the principles upon which organizations should base their corporate governance, but may be less clear and provide less uniformity between firms than rules-based regulation.

14. Search the Internet for the SEC's comments on which method they prefer.

Internet information on the SEC's comments regarding rules-based and principles-based regulation may be found at: sec.gov. The SEC seems to largely embrace the principles-based approach for creating legislation. In this manner, the principles of the law are promoted so that organizations will not just have a "check-box" compliance mentality. Organizations may be prone to follow the principles underlying regulations in a principles-based regulation than in a rules-based counterpart.

15. Discuss the advantages and disadvantages of both a regulatory-led and a shareholder-led approach to corporate governance.

In the U.S., corporate governance reforms are influenced by a combination of state laws, federal laws, and regulations, listing standards of national stock exchanges, and best practices of professional organizations. This approach to the development of corporate governance reforms is often referred to as a regulatory-led system. State laws govern the internal mechanisms of corporate governance including directors' duties and shareholder rights whereas policymakers, regulators, stock exchanges, and best practices play an important role in the governance of listed companies. This regulatory-led approach has a tendency of promoting a rules-based approach to corporate governance reforms. The advantages of this approach are: (1) more enforceable compliance procedures; and (2) quicker regulatory response to assess and correct corporate governance ineffectiveness and breakdowns.

In the U.K., the government allows the market to establish corporate governance best practices, leading to the development of the Combined Code which requires a "comply-or-explain" approach to corporate governance. This approach is referred to as a shareholder-led approach to good corporate governance primarily because shareholders play an active role in its development. The primary advantage of this approach is that it is regarded as a principles-based or a self-regulatory approach to good governance with the main theme of comply-or-explain with lower compliance costs. The primary disadvantage is that it is less enforceable and mainly relies on the ability of shareholders to monitor boards through rights accorded to them in company legislation. A regulatory-led approach can be effective in building overall market confidence, whereas a shareholder-led approach promotes more scalable corporate governance.

True or False

1. All public companies have the same structure for their corporate governance.
2. Examples of external governance mechanisms are the board of directors, the audit committee, management, internal controls, and internal audit functions.
3. The three aspects of corporate governance are integrated, shareholder, and stakeholder.
4. Value creation is the primary goal of the stakeholder aspect.
5. Shareholders are a type of stakeholder.
6. The integrated aspect combines the shareholder and stakeholder aspects but puts emphasis on the shareholder aspect.
7. Honesty means telling the truth when it is most beneficial to the company.
8. Shareholders are primarily responsible for the monitory function of corporate governance.
9. An important principle of effective corporate governance is its transparency of not only financial information, but also operations and structures.
10. The board of directors is held personally liable for all damages caused by decisions that resulted in unsuccessful conclusions.
11. Corporate governance reporting is now required by all public companies due to the

Sarbanes-Oxley act of 2002.

12. Governance rating agencies may be held liable for investors' decisions and be required to pay damages.
13. Separation of control and ownership is the primary cause of agency problems.
14. An example of a market correction mechanism would be a dissatisfied shareholder selling off his or her shares in a corporation.
15. Rules-based corporate governance is considered the "spirit of the law" approach.
16. Securities laws set minimum requirements for companies offering securities to the public and require investors to be presented with accurate, relevant, and useful financial information.
17. MNCs are only influenced by the home country when evaluating and developing their corporate governance structure.
18. There is no universally accepted definition of corporate governance primarily because its concept is not well defined, it covers various distinct economic phenomena, and it is often described from the shareholders' view.
19. The primary purpose of corporate governance is to create and enhance long-term, endurable, and sustainable management value.
20. Corporate governance has evolved from its role of reducing agency costs to creating long-term shareholder value, and, recently, to increasing sustainable and enduring value for all stakeholders.
21. The shareholder aspect of corporate governance focuses on shareholder value creation and the enhancement goal of corporate governance.
22. The integrated aspect concentrates on both the shareholder value creation and stakeholder value protection goals of corporate governance.
23. The agency problem exists when the desires and interests of management and shareholders are in accord and when there are no difficulties in verifying management activities.
24. In the real world, the agency problem can never be perfectly solved, and agency costs cannot be totally eliminated.
25. The CEO, as representative of investors, has direct authority and responsibility to govern business affairs and is accountable to investors for the company's strategic performance.
26. Executive compensation should be linked to performance, be established and approved by the management of the company, and be given the advisory approval of the CEO.
27. There is no globally accepted corporate governance structure.
28. There is no globally accepted set of corporate governance principles that can be applied across a broad range of board structures, business practices, and legal, political, and economic environments.
29. Transparency means that the company is not hiding relevant information, and disclosures are fair, accurate, reliable, and understandable by average stakeholders.
30. The use of majority voting as apposed to plurality voting substantially reduces the ability and influence of shareholders over who is actually elected to the board.

31. The oversight function is granted to the board of directors with the fiduciary duty of overseeing management in the best interests of the company and its shareholders.
32. The managerial function is given to the board of directors in order to run the company and manage its resources and operations.
33. The monitoring function is exercised by shareholders (and particularly institutional shareholders who are empowered to elect, and if warranted, remove directors).

True or False

1. False
2. False
3. True
4. False
5. True
6. True
7. False
8. True
9. True
10. False
11. False
12. False
13. True
14. True
15. False
16. True
17. False
18. True
19. False
20. True
21. True
22. True
23. False
24. True
25. False
26. False
27. True
28. True
29. True
30. False
31. True
32. False
33. True

Multiple Choice

1. The corporate governance structure of a company reflects the individual companies':

a. Cultural and economic system.
b. Legal and business system.
c. Social and regulatory system.
d. All of the above.

2. **External governance mechanisms such as the capital market and state and federal regulations are designed to:**
   a. Keep companies from providing a large earnings-per-share.
   b. Align the interests of insiders with the interests of outsiders.
   c. Prohibit corporate takeover efforts.
   d. Ensure management makes budget.
3. **Which of the following statements is not true concerning corporate governance mechanisms?**
   a. The effectiveness of corporate governance mechanisms also depends on the cost-benefit trade-offs among these mechanisms.
   b. Corporate governance mechanisms create effective systems of checks and balances.
   c. Internal and external mechanisms work best when used independently of the other.
   d. None of the above are true statements.
4. **All of the following describe agency problems and costs *except*:**
   a. The agency problem exists when the desires of management and shareholders are not in accord.
   b. Agency costs arise where there is "information asymmetry" between management and shareholders.
   c. Agency problems can be perfectly solved and agency costs can be totally eliminated.
   d. The agency problem exists when the company's board of directors fails to fulfill their assigned oversight role.
5. **Value protection is intended to protect the interests of all stakeholders. Such interests include:**
   a. Government—tax revenue.
   b. Employee—job security.
   c. Shareholder—wealth (stock appreciation and dividends).
   d. All of the above.
6. **A well-balanced implementation of the seven corporate governance functions should not result in:**
   a. Responsible corporate governance.
   b. Reliable financial reports.
   c. Harm to the company.
   d. Credible audit services.
7. **Which of the following statements best describes the compliance function?**
   a. The compliance function is composed of a set of laws, regulations, rules, and standards established by state and federal legislators which are followed only when beneficial.
   b. Compliance is following your internal bylaws and regulations.
   c. The compliance function is composed of a set of laws, regulations, rules, and

standards established by state and federal legislators which must be followed regardless of the cost.

d. Compliance is a nuisance that deters from the company's main goal of making money.

8. The internal audit function is least effective when the department:

a. Is nonindependent.
b. Is competent.
c. Is objective.
d. Exhibits integrity.

9. Which of the following statements is true?

a. An external audit can be performed by anyone with an accounting degree.
b. An external audit is required for any company with annual revenues greater than $5 million.
c. An external audit is designed to prove that the financial statements are wrong.
d. An external audit must be performed by an independent, public accounting firm.

10. Which of the following would be considered the least effective and appropriate best practice of a public company?

a. Executive compensation programs should be designed and implemented to ensure alignment of interest with the long-term interests of shareowners.
b. The CEO and chairperson of the board should be the same individual to allow for the congruence of management and director interests.
c. The board of a publicly owned corporation should have a substantial degree of independence from management.
d. The board does not impose term limits, as this could unnecessarily interfere with the continuity, diversity, developed experience and knowledge, and long-term outlook the board must have.

11. Corporate governance reports are recommended to include all of the following disclosures *except*:

a. The company's vision, strategies, and missions in creating stakeholder value.
b. The board of director's composition, independence, involvements, functions, and evaluation.
c. Competitive trade secrets and research reports.
d. The company's financial, economic, social, and environmental indicators.

12. Which of the following is false concerning market mechanisms?

a. Market mechanisms are used to monitor, control, and discipline business affairs.
b. Market mechanisms are effective as the only control structure.
c. Market mechanisms require additional corporate governance reforms to provide adequate controls.
d. Market mechanisms were discussed as early as 1776.

13. The Sarbanes-Oxley Act of 2002 provided guidance for all of the following *except*:

a. Executive certifications of internal controls and financial statements.
b. Limits on executive and director pay.
c. Audit committee oversight of financial reporting and audit activities.
d. Director independence.

14. Which of the following would be considered principles-based?
   a. Step-by-step directions for a temp worker.
   b. Best practices.
   c. U.S. GAAP.
   d. Shareholder voting procedures.

15. Corporate governance in the United States is influenced by:
   a. State and federal statutes.
   b. Court decisions.
   c. Listing standards and best practices.
   d. All of the above.

16. The Combined Code is the leading corporate governance directive for:
   a. The United States.
   b. Germany.
   c. The United Kingdom.
   d. Japan.

17. The corporate governance structure is shaped by:
   a. Internal governance mechanisms.
   b. External governance mechanisms.
   c. Policy interventions through regulations.
   d. All of the above.

18. An example of an internal governance mechanism is a(n):
   a. Shareholder activist.
   b. Shareholder proposal.
   c. Audit committee.
   d. Federal statute.

19. The ownership structure that may best characterize a situation in which a typical shareholder may have little power to control the company's affairs beyond voting power to elect members of the board of directors is:
   a. Centralized ownership structure.
   b. Dispersed ownership structure.
   c. Two-tier ownership structure.
   d. None of the above.

20. Under the _____________, both internal and external corporate governance mechanisms are intended to induce managerial actions that maximize profit and shareholder value.
   a. Shareholder theory.
   b. Agency theory.
   c. Stakeholder theory.
   d. Corporate governance theory.

21. Which of the following is not a primary source of corporate governance in the U.S.?
   a. Federal securities laws.
   b. Best practices.

c. Listing standards.
d. All of the above are primary sources of corporate governance in the U.S.

22. One of the objectives of the Sarbanes-Oxley Act was to:

a. Increase the cost of compliance with federal regulations.
b. Force foreign companies to delist from U.S. capital market exchanges.
c. Improve the quality and transparency of financial reporting.
d. Increase the compliance burden for small companies.

23. Which of the following is false?

a. Public companies do not usually report their corporate governance activities.
b. Corporate governance reporting reports the effectiveness, responsiveness, and credibility of an organization's corporate governance measures.
c. Corporate governance reports are required to be prepared in conjunction with the annual 10-k filed with the SEC.
d. Corporate governance standards should be developed to assess, attest to, and report on the quality and effectiveness of corporate governance.

24. Which of the following is not an aspect of corporate governance reporting/disclosures?

a. Financial position and earnings analysis.
b. Compensation policy for directors and officers.
c. Material information on multiple bottom lines sustainability performance.
d. Major share ownership and voting rights.

<u>Multiple Choice</u>

1. d.
2. b.
3. c.
4. c.
5. d.
6. c.
7. c.
8. a.
9. d.
10. b.
11. c.
12. b.
13. b.
14. b.
15. d.
16. c.
17. d.
18. c.
19. b.
20. b.
21. d.

22. c.
23. c.
24. a.

Chapter 3

Review Questions

1. **What are the three ethical classifications and their purposes discussed by the author?**

    Metaethics:
    - Focus on ethical theories, their evolution, and the social, religious, spiritual, and cultural influences shaping those theories.

    Normative ethics:
    - Emphasize the practical aspects of ethics by providing principles of appropriate behavior and guidance for what is right and wrong, good or bad in behavior (e.g. principles of justice, honesty, social benefits, and lawfulness).

    Applied ethics:
    - Deal with the application of moral principles and reasoning as well as codes of conduct for a particular profession or segment of the society (e.g. business ethics, environmental ethics, and medical ethics).
2. **What factors can lead to a company engaging in corporate misconduct of misrepresenting their financial position?**
    - Performance is below their industry's average performance.
    - Performance is significantly above their own past performance.
    - Their CEO receives a high proportion of total compensation as stock options.
3. **Explain the terms of the phrase "organizational ethical culture."**
    - Organization is defined as a group of individuals or entities bound to achieve a shared goal.
    - Ethics are honorable behavior conforming to the norm of the group.
    - Culture is a pattern of shared beliefs adopted by the group in dealing with its internal and external affairs.
4. **From start to finish, what are the steps required to make an ethical decision?**

    The process of making ethical decisions starts with the commitment to do the right thing by: (1) recognizing the relevant issue, event, or decision; (2) evaluating all alternative courses of action and their impacts on one's well-being as well as the well-being of others possibly affected by the decisions; (3) deciding on the best course of action available; (4) consulting appropriate ethical guidance; (5) continuously assessing the consequences of the decision and adopting appropriate changes; and (6) implementing the decision.
5. **What are situational ethics?**

    Situation ethics are a moral pattern allowing circumstances to overrule principle and allegiance where principle means definable moral, criminal, or civil law and allegiance means group loyalty.
6. **What are the attributes of an ethical culture?**
    - sense of employee responsibility.

- freedom to raise concerns without fear of retaliation.
- managers modeling ethical behavior and expressing the importance of integrity.
- an understanding by leadership of the pressure points that drive unethical behavior.
- processes to find and fix these areas of pressure.

7. What is meant by the term ethics sensitivity?

It is the moral principles, workplace factors, gamesmanship, loyalty, peer pressure, and job security that influence one's ethical decisions and are derived from the organization's ethical culture.

8. Explain the sources of incentives for ethically based behavior.

- individual-based incentives.
- organization-based incentives.
- market-based incentives.
- profession-based incentives.
- regulatory-based incentives.

9. Explain organization-based incentives and profession-based incentives.

Organization-based incentives:

- Come from setting an appropriate tone at the top and establishing, maintaining, and enforcing ethical behavior throughout the organization.
- Go beyond promoting corporate values of integrity, fairness, and honesty.
- Include a set of principles that require ethical behavior.

Profession-based incentives:

- Profession-based incentives are defined by a professional affiliation of individuals.
- Professional codes of conduct serve as a reference and a benchmark for individuals, establish rules of conduct relevant to the profession, and provide a means of facilitating enforcements of rules and standards of conduct.

10. What is meant by the term "ethical behavior"?

It is the process of recognizing ethical issues, considering all alternative courses of action, referring to ethical incentives to guide the best actions, evaluating the consequences of ethical decisions, and proceeding with confidence.

11. What are the six principles of business ethics and conduct?

- Comply with a written code of business conduct.
- Provide sufficient training to all personnel within their organization regarding personal responsibility under the code.
- Encourage internal reporting of violations of the code with the promise of no retaliation for such reporting.
- Self-govern their activities by implementing controls to monitor compliance with all applicable laws and regulations.
- Share their best practices in implementing the DII principles through participation in an annual Best Practices Forum.
- Be accountable to the public, particularly through the completion of an annual Public Accountability Questionnaire.

Discussion Questions

1. **What are ethics? Explain.**

   Ethics are broadly described in the literature as moral principles about right and wrong, honorable behavior reflecting values, or standards of conduct. Honesty, openness, responsiveness, accountability, due diligence, and fairness are core ethical principles. Ethics are a branch of philosophy with no clear-cut definition of what behaviors are ethical and which are unethical when judging one's behavior. There is no general or global consensus for defining ethical behavior for individuals, as it may change from time to time and from one place to another place. There is no universal measure or standard as to what constitutes ethical behavior. Business ethics are most simply described as: a process of promoting moral principles and standards that guide business behavior.

2. **Do you believe moral principles and ethics are a part of family values which cannot be taught? Substantiate your answer.**

   Business ethics can be promoted and taught to improve professional reputation, accountability, integrity, judgment, and other qualities of the business decision-making process. Setting the appropriate "tone at the top" promoting ethical organization, culture, and policies can effectively influence individuals' behavior. Teaching business ethics should provide incentives, opportunities, and rationalization for individuals, particularly professionals, to uphold their personal integrity and professional accountability.

3. **Companies that do not have a code of ethics must either establish such a code or disclose why they have not implemented a code. What factors would lead a company to not develop a code of ethics?**

   Public companies that do not have a code of ethics must establish a code that meets the requirements of the SEC final rule. Public companies with an existing code of ethics must ensure that their existing code satisfies SEC requirements or otherwise revise their code to meet the requirements; if not, they must be prepared to disclose why they have not adopted a qualifying code of ethics. Inability to set the right "tone at the top", improper corporate culture, and disregard for ethical behavior may be factors that would lead a company to not develop a code of ethics.

4. **Do you feel a company should provide incentives and opportunities for the majority of ethical individuals to maintain their honesty and integrity and at the same time provide measures for the unethical individuals to be monitored, punished, and corrected for their unethical conduct? Explain why.**

   Yes, because ethics in business has an important underlying postulate that the majority of business leaders, managers, and other personnel are honest and ethical in conducting their business and the minority who engage in unethical conduct will not prevail in the long term.

5. **In what ways can doing what is right contrast with established principles and procedures?**

   Situation ethics "is a moral pattern allowing circumstances to overrule principle and allegiance. Principle here is interpreted as definable moral, criminal, or civil law. Allegiance refers to group loyalty." This suggests that individuals should do what is right rather than comply with specific principles when facing ethical challenges. Circumstances may arise in which actions prescribed by various rules and regulations may conflict with doing what is right, or conduct may take place which is contradictory with the "spirit of the law" and yet allowed by the various rules and regulations.

6. **Are people motivated more by incentives to do what is right or by the self-pride of doing what is right? Explain.**

   In most cases, people may be motivated more by incentives to do what is right than the self-pride of doing what is right. Individuals within the company tend to act according to incentives provided to them in terms of rewards and the performance-evaluation process. People usually would rather take pride in the rewards and benefits received by established incentives than simply by the fact that they have done what is right.

7. **Has the ethical downfall of major corporations ultimately helped build a more ethical business world? Defend your answer.**

   The ethical downfall of major corporations has alerted many regulators (among others) to the need for ethical behavior in the corporate environment. This has prompted swift legislation (e.g. Sarbanes-Oxley) designed to promote ethics and propriety in the workplace. Ethics, as a result, is no longer practiced as a seemingly voluntary process. Legislation that promotes ethical practice may now aid in building a more ethical business world. Another result of the ethical downfall of major corporations is the increased vigilance of corporate stakeholders. Corporations know that, since they are now scrutinized to a larger degree, they must at least provide the appearance of ethical behavior. If they do not, they may face even more scrutiny by various stakeholders. Thus, the ethical downfall of major corporations has alerted society to the need for increased regulation and vigilance designed to promote ethical behavior. This has, in turn, helped build a more ethical business world.

True or False

1. An appropriate code of ethics is the backbone of effective corporate governance.
2. Many tragedies and scandals are directly related to the ethical behavior of individuals involved and their activities.
3. Codes of business ethics and conduct can be effective substitutes for moral principles, character, and culture of individuals and organizations.
4. Management has a fiduciary responsibility for stakeholder value creation.
5. According to the SEC, the established code of ethics best describes the company's policies and procedures for internal reporting of code violations.
6. Individuals should follow specific principles rather than what is right while facing ethical challenges.
7. The NYSE listing standards recommend that each listed company determine its own business conduct and ethics policies.
8. Ethics in the workplace is more important in the emerging corporate governance reforms.
9. Individual-based incentives relate to personal integrity and are the primary driver of ethical behavior.
10. Defense contractors are exempted from accountability to the public as stated in

the Defense Industry Initiatives on Business Ethics and Conduct (DII).

True or False

1. True
2. True
3. False
4. True
5. True
6. False
7. True
8. True
9. True
10. False

Multiple Choice Questions

1. **Which of the following is/are the key component(s) of an organization's control environment as set forth in both reports of the Committee of Sponsoring Organizations of the Treadway Commission (COSO)?**
   a. Integrity.
   b. Ethical conduct.
   c. Both (a) and (b).
   d. Neither (a) nor (b).
2. **Which of the following is not a factor that can lead to companies misrepresenting their financial position?**
   a. Performance is below their industry's average performance.
   b. Performance is significantly above their own past performance.
   c. The company has an established and well-defined code of corporate ethics.
   d. Their CEO receives a high proportion of total compensation as stock options.
3. **Public companies must make their code of ethics publicly available through:**
   a. SEC annual reports.
   b. Corporate Web sites (if available).
   c. Hard copies (upon request).
   d. All of the above.
4. **The Web site disclosure required for amendments and waivers to the code of ethics must be maintained online for which of the following:**
   a. 12 months or otherwise be retained for at least five years.
   b. 24 months or otherwise be retained for at least five years.
   c. 5 months or otherwise be retained for at least five years.
   d. 12 months or otherwise be retained for at least two years.
5. **The increasing trend toward more involvement of the board of directors in the company's ethics program is influenced by:**
   a. Consequences of reported financial scandals.
   b. Auditors of low-profile companies.
   c. Development of corporate governance reforms in promoting ethical conduct.
   d. Both (a) and (c).
6. **Companies need ethics and business programs in order to effectively and**

efficiently perform which of the following functions?
a. Diversify personnel services.
b. Satisfy the expectations of the public and their stakeholders.
c. Comply with applicable laws, regulations, rules, standards, and guidelines.
d. All of the above.

7. **An organization's appropriate tone at the top promoting ethical conduct is an example of:**
   a. Ethics sensitivity.
   b. Ethics incentives.
   c. Ethical behavior.
   d. Consequentialist.
8. **The two broadly defined and commonly accepted ethical theories are:**
   a. Consequentialism and nonconsequentialism.
   b. Egoism and utilitarianism.
   c. Consequentialism and egoism.
   d. Consequentialism and utilitarianism.
9. **A consequence of reducing costs by lowering the quality of products and services is an example of:**
   a. Regulatory-based incentives.
   b. Market-based incentives.
   c. Organization-based incentives.
   d. Individual-based incentives.
10. **Signatory companies, as part of their public accountability process, are required to:**
   a. Conduct internal audits.
   b. Assess compliance of internal audits.
   c. Provide officer certifications.
   d. All of the above.

Multiple Choice Questions

1. c.
2. c.
3. d.
4. a.
5. d.
6. d.
7. b.
8. a.
9. b.
10. d.

Chapter 4

Review Questions

1. What is the difference between decision management and decision control?

Decision management is management's responsibility of initiating and implementing strategies, and decision control is the board of director's fiduciary duty of ratifying and monitoring strategies.

2. Briefly explain the business judgment rule and the benefit it provides to directors.

A court will refuse to review the actions of a corporation's board of directors in managing the corporation unless there is some allegation of a violation of the directors' fiduciary duties or the decisions of the directors lack a rational basis. The business judgment rule eases the liability and pressure on directors.

3. What is the relationship between the supervisory and management boards of a two-tiered board system?

The supervisory board has as its primary objective the duty and responsibility to appoint, dismiss, and oversee the management board.

4. Why are investors in favor of separation of the positions of CEO and chairperson?

Separation is perceived as strengthening the board's independence and reducing potential conflicts of interest.

5. What is a financial expert?

A person who has an understanding of generally accepted accounting principles and financial statements; experience applying generally accepted accounting principles; experience preparing or auditing financial statements; experience with internal controls and procedures for financial reporting; and an understanding of audit committee functions.

6. Why is it important for a company to have an appropriately sized board of directors?

The size of the board can affect the efficiency and effectiveness of the board of directors.

7. Briefly discuss the benefits of small and large board sizes.

A small board is considered to be efficient because the process of deliberation becomes time consuming and unwieldy with large boards. A large board can be more effective in monitoring managerial actions primarily because by increasing the number of directors involved with monitoring, management may decrease the opportunity for wrongdoing and collusion becomes more difficult.

8. What are the direct responsibilities of the board of directors?

The board of directors is directly responsible for defining the company's objectives; establishing policies and procedures to ensure achievement of defined objectives; monitoring the established policies and procedures; assuming ultimate accountability for the company's business and affairs; and ensuring that the company is conducting its business in the utmost ethical, legal, and professional manner to create long-term shareholder value while protecting the interests of other stakeholders.

9. Board independence is essential for what purposes?

The independence of the company's board of directors is important because it has a significant impact on its effectiveness and is essential to the proper and objective functioning of the board.

10. What responsibility does the compensation committee have towards the remuneration of board members?

The compensation committee should determine the amount and percentage of executive stock ownership that will motivate them to align their interests with those of shareholders.

11. How does the board of directors oversee corporate governance?

The board of directors: (1) monitors management plans, decisions, and activities; (2) acts as an independent leader who takes initiatives that create shareholder value; (3) establishes guidelines or operational procedures for its own functioning; (4) meets periodically without management presence to assess company and management performance and strategy; (5) evaluates its own performance to ensure that the board is independent, professional, and active; and (6) establishes the audit committee that oversees the financial reporting process, internal control structure, and audit functions.

Discussion Questions

1. Discuss the importance and objectives of directors' fiduciary duties to the company.

The fiduciary duty means that, as shareholder's guardians, directors are trustworthy, acting in the best interest of shareholders, and investors in turn have confidence in the directors' actions. Fiduciary duties of boards of directors are mandated by the laws of the state of incorporation, are generally specified in the company's charter and bylaws, and are often interpreted by courts when there are allegations of breach of fiduciary duties. Directors should realize that their primary duty is to be the corporate gatekeeper by protecting investors and working towards the achievement of shareholder value creation and enhancement while protecting the interests of other stakeholders.

2. What are possible situations that could jeopardize a director's duty to avoid conflicts of interest?

Situations that may create potential conflicts of interest are when a director: (1) receives material gifts or benefits from a third party that is doing business with the company; (2) either directly or indirectly enters into a transaction or arrangement with the company; (3) obtains substantial loans from the company; or (4) engages in backdated stock options.

3. Do you support CEO duality in a public company? Defend your response.

Answers may vary. Proponents of the dual CEO position have argued that no gains will be achieved by separating the CEO and chairperson positions on the grounds that existing corporate governance reforms have already addressed the CEO's potential conflicts of interest by requiring that: (1) the independent compensation committee monitor CEO compensation; and (2) the board of directors, particularly the lead director, control the CEO's power in situations where the CEO encounters conflicts of interest, the CEO is aggressive, or where there is a long-term and gradual failure of the company's business plan. The potential benefits of the separation of the CEO and chair positions are: (1) such separation aligns U.S. corporate governance with that of other countries; (2) CEO accountability is improved; (3) CEO potential conflicts of interest are reduced; (4) having two individuals in the corporate leadership role should improve corporate governance and operations; and (5) the board responsibility to oversee management for shareholders' benefit would be more effective when the chair of the board assumes no executive role.

4. Why is it important for the members of the board of directors to have business knowledge and financial expertise?

Adequate business knowledge and financial expertise allow members of the board of directors to effectively fulfill its fiduciary duties. Board members may not be able to perform their fiduciary duties in the absence of such business knowledge and financial expertise.

5. In your opinion, who should be allowed to serve as a director of a public company?

Answers may vary. Board members should possess the technical skills, financial expertise, experiences, and other qualifications to effectively fulfill their fiduciary responsibilities. They should be competent and independent of management in order to assure effective corporate governance.

6. Is a board that meets more often for shorter periods of time more effective and efficient than a board that meets less frequently but for a longer period of time? Explain.

Answers may vary. Short, frequent meetings may be just as effective as long, infrequent meetings and vice-versa. The board of directors is required to meet regularly to discuss the company's business affairs and financial reports with and without the presence of management. The effectiveness of board meetings depends largely on the leadership ability of the chairperson of the board to set an agenda and direct discussions. The leadership style and ability of the chair determines whether the meetings will be short or lengthy, formal or informal, friendly or adversarial, relaxed or tense, efficient or inefficient, productive or nonproductive, responsive or nonresponsive, relevant or irrelevant, decisive or indecisive, and predetermined or deliberative.

7. Discuss the impact of the Business Judgment Rule on directors' ability to fulfill their fiduciary duties.

There are some variations in director fiduciary duties as company law differs from one state to another. However, directors are empowered to manage the affairs of a company, and directors must exercise their powers in the best interests of the company and its shareholders. In fulfilling their fiduciary duties of care and loyalty, directors are governed by the business judgment rules of exercising their best judgments in aligning management interests with those of shareholders and in creating shareholder value. The business judgment rule is intended to protect directors from undue liability when making business decisions in good faith and in the best interests of the company and its shareholders.

8. Compare and contrast the roles and responsibilities of executive and nonexecutive directors.

The majority of directors in the post-SOX period should be independent nonexecutive directors who work collectively with executive directors in the best interests of the company and its shareholders. The primary responsibility of the board of directors is to hire a competent and ethical management team to run the company effectively. Executive directors are typically engaged in strategic decision making, planning, and execution of plans whereas nonexecutive directors advise and oversee managerial plans, decisions, and actions without micromanaging.

9. Describe both advantages and disadvantages of CEO duality.

CEO duality means that the roles of the chair of the board and CEO are combined. The primary advantage of CEO duality is more control of the company's affairs by the CEO in bringing more uniform leadership into the boardroom. Advantages of separation of the roles of the chair and the CEO are: (1) providing guidance and advisory services to the CEO; (2) playing a leadership role in influencing the board's agenda and facilitating board meetings; (3) overseeing the performance of the CEO; and (4) creating a more open and candid boardroom that promotes constructive and frank discussion.

10. Discuss how the levels of executive compensation should be determined.

Executive compensation is normally composed of a basic salary, annual bonus, long-term awards including stocks and share options, pension benefits, and perks. As a general rule, executive compensation should be linked directly to the company's long-term performance to ensure alignment of executives' interests with sustainable shareholder value creation. Executive compensation, however, in practice is determined in relation to the market rate of pay and the level of pay in companies of similar size, complexity, and industry. Significant drivers of executive compensation are the company's long-term performance, shareholder returns, and ability to create sustainable shareholder value.

True or False

1. Decision management duties are the responsibility of management and are the ratification and monitoring of strategies.
2. The board of directors should not be involved in managerial and operational decisions.
3. The duty of care requires directors to exercise due diligence and prudence in carrying out their oversight function.
4. A one-tier board model consists of only outside directors.
5. All public companies are required to have a board of directors but are not required to have a chairperson.
6. CEO duality implies that the company's CEO holds both the position of chief executive and the chair of the board of directors.
7. A permanent or rotating lead director is used as an alternative to separating the CEO and chairperson positions.
8. The board of directors for all public companies must have at least three members.
9. Directors may only serve as a director on one board per year.
10. Resources available to the board consist of legal, financial, and information resources.
11. Directors of all public companies are required to own shares in their company.

True or False

1. False
2. True

3. True
4. False
5. False
6. True
7. True
8. False
9. False
10. True
11. False

Multiple Choice

1. The primary responsibilities of the board of directors include all but which of the following:
   a. Define the company's mission and goals.
   b. Establish or approve strategic plans and decisions to achieve these goals.
   c. Appoint senior executives to manage the company in accordance with the established strategies, plans, policies, and procedures.
   d. Make managerial decisions that will increase the company's stock price.

2. The oversight function of the board of directors consists of:
   a. Representing shareholders and protecting their interests.
   b. Approving the company's major operating, investing, and financial activities.
   c. Holding the board, its committees, and its directors accountable for the fulfillment of the assigned fiduciary duties and oversight functions.
   d. All of the above.

3. A director who notifies the company of a possible investment opportunity instead of acting upon it himself is demonstrating the:
   a. Duty of obedience.
   b. Duty of loyalty.
   c. Duty of care.
   d. Duty of fair disclosure.

4. Ratification of management decisions and minimal liability defines which best practices board structure?
   a. Certifying board.
   b. Operating board.
   c. Passive board.
   d. Intervening board.

5. Management's implementation of board strategies and the board serving as the key decision maker are best associated with:
   a. Certifying board.
   b. Operating board.
   c. Passive board.
   d. Intervening board.

6. The chairperson of the board of directors and CEO should be leaders with:
   a. Vision and problem solving skills.
   b. The ability to motivate.
   c. Business acumen.

d. All of the above.

7. The director position that is utilized in CEO duality situations to keep the board objective and independent of management is the:

a. Lead director.
b. Covering director.
c. Prime director.
d. None of the above.

8. Which of the following can be diversification classifications?

a. Age.
b. Gender.
c. Ethnicity.
d. All of the above.

9. The structure of a public company's board of directors is established by its:

a. Articles of incorporation.
b. Bylaws.
c. Corporate governance policies.
d. All of the above.

10. Financial resources are made available to the board for all of the following except:

a. Compensating directors.
b. Reimbursing personal expenses.
c. Hiring external auditors.
d. Obtaining legal council.

11. An independent director is one who:

a. Did not attend a school supported by the company.
b. Does not have outside relationships with other directors.
c. Does not have any other relationships with the company other than his or her directorship.
d. All of the above.

12. A board that is elected in a classified system is known as a:

a. Diversified board.
b. Staggered board.
c. Rotating board.
d. Declassified board.

13. Insurance payable to the directors and officers of a company if they get sued for something that happened while they were with that company is known as:

a. Duties & obligations insurance.
b. Disaster & occurrence insurance.
c. Director & officer insurance.
d. Duty & opportunity insurance.

Multiple Choice

1. d.
2. d.
3. b.
4. c.

5. b.
6. d.
7. a.
8. d.
9. d.
10. b.
11. c.
12. b.
13. c.

Chapter 5

Review Questions

1. **What are the key functions of the nominating, audit, governance, and compensation committees?**

   The nominating committee is responsible for:
   - Reviewing the performance of the current directors.
   - Assessing the need for new directors.
   - Identifying and evaluating the skills, background, diversity, and knowledge of candidates for the board.
   - Having an objective nominating process for qualified candidates to the board.
   - Assisting in the election of qualified new directors.

   The audit committee is responsible for:
   - Overseeing the financial reporting process.
   - Monitoring the choice of accounting policies and principles.
   - Monitoring the internal control process.
   - Overseeing the hiring and performance of external auditors.

   The corporate governance committee is responsible for:
   - Establishing the agenda for the board of directors to determine what the board should discuss with management and to what extent.

   The compensation committee is responsible for:
   - Evaluating the performance of directors.
   - Evaluating the performance of executives.
   - Designing and implementing compensation plans for directors and executives.
   - Disclosing the work of the compensation committee.
2. **What actions must be taken to make the compensation committee effective?**

   The compensation committee should be composed of independent outside directors with sufficient human resources experience in compensation and related issues. Also this committee should hire outside compensation advisors that report directly to and are compensated by the committee to ensure objectivity.
3. **List the principles and practices for ensuring the effectiveness of the compensation committee as recommended by The Council of Institutional Investors (CII).**
   - Structure.
   - Proxy statement disclosure.

- Responsibilities.

4. **Briefly discuss the criteria or benchmarks used by the compensation committee in the evaluation process.**
   - Knowledge, experience, and expertise.
   - Teamwork and leadership ability.
   - Maturity, objectivity, judgment, and independence.
   - Value-added contribution to the company's welfare.
   - Understanding of the company's business and industry including legal and financial literacy.
   - Firm commitment and dedication to working towards the achievement of the company's goals.
   - Safeguarding of the company's assets, ensuring integrity of its financial reports, and protecting the interest of shareholders.
   - Creating long-term shareholder value.
   - Protecting the interests of all stakeholders.
   - Setting an appropriate tone at the top in promoting ethical conduct.
5. **What are the responsibilities of the corporate governance committee?**
   - Control the agenda and the meeting.
   - Review past agendas and minutes of meetings to ensure adequate time and discussion were devoted to each issue.
   - Revise the agenda as necessary and set priorities for meetings.
6. **List the issues the nominating committee should consider in the evaluation process.**
   - The gender and ethnic diversity of the board in creating a right balance to address the current and future challenges of the business while being challenging yet supportive of the top management team, as appropriate.
   - The experience necessary to operate board committees.
   - Future expertise needs of the board.
   - Regular refreshment of the board.
   - A right mix of director qualifications and behavioral characteristics.
7. **What characteristics define a good director?**
   - Asks the difficult questions.
   - Works well with others.
   - Has industry experience and awareness.
   - Provides valuable input.
   - Is available when needed.
   - Is alert and inquisitive.
   - Has business knowledge.
   - Contributes to committee work.
   - Attends meetings.
   - Speaks out appropriately at board meetings.
   - Prepares for meeting.
   - Assures responsibility and accountability.
   - Is familiar with or willing to learn about emerging corporate governance reforms

and applicable regulations and best practices.

- Communicates effectively with all corporate stakeholders.
- Supports the company’s economic, ethical, social, and environmental measures.

8. **List any two functions of following committees:**

Nominating committee

Recommends, nominates, and elects directors.

Audit committee

Oversee internal controls, risk management, financial reporting, and audit activities.

Governance committee

Advises, reviews, and approves management strategic plans, decisions, and actions in effectively managing the company.

Compensation committee

Implements and supports the oversight function of the board particularly in areas relevant to the design and review of director and executive evaluation and compensation schemes.

9. What is needed for the oversight function of audit committees to be effective?

Independence, due diligence, proper authority, resources, corporate culture, governance structure, attitude, philosophy, and practices of management and the entire board of directors.

10. Describe the relationship that should exist between the audit committee and management.

The audit committee should interact with management by asking appropriate questions pertaining to the company’s corporate governance structure, internal controls, financial reporting, audit activities, risk assessment, codes of ethics, and whistleblower programs.

11. Members of the audit committee must be vigilant, effective, and informed. What are some characteristics that contribute to these traits?

(1) General understanding of the company’s major economic, business, operating, and financial risk; (2) a broad knowledge of the interrelationship of the company’s operations and financial reporting; (3) a clear understanding of the difference between the company’s decision-making function delegated to management and its oversight function assumed by the audit committee; (4) the ability to formulate and ask probing questions about the company’s operations, business, internal control, financial reporting process, and audit activities; and (5) courage to challenge management when necessary.

12. What are some qualities or actions that can impede the effectiveness of an audit committee?

- A lack of true independence from management.
- Infrequent or ineffective meetings.
- A lack of sufficient understanding of the company’s business and operations.
- Inadequate understanding of internal controls, audit scope, plan, policies and procedures, and financial reporting practices.
- A lack of proper communication with management, the internal auditor, and external auditors.

- Inadequate resources including access to legal counsel and advisors.
- Insufficient staff support.
- Lack of exercising due diligence.
- Unclear mission and undefined authority in the committee charter.
- Insufficient number of qualified committee members.
- Inadequate compensation to demand high-quality performance.
- Lack of accountability for committee performance.

13. The text discusses the qualifications and characteristics of an audit committee financial expert. In your own words, define what a financial expert should be.

Answers may vary. The SEC final rules define an audit committee financial expert as a person who has all of the following attributes:

- An understanding of GAAP and financial statements.
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves.
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the issues that can be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities.
- An understanding of internal controls and procedures for financial reporting, and an understanding of audit committee functions.

14. What are the positives and negatives of the CEO and executive management's attendance at audit committee meetings?

It can signal the commitment of senior executives to the achievement of effective audit committee oversight functions as well as underscore the importance of those meetings. On the other hand, it may prevent open and candid dialogue between the independent auditor and the audit committee or undermine the authority of the committee chair.

15. What disclosures must the audit committee make in its report to shareholders?

A description of audit committee responsibilities, its activities and accomplishments, and its self-assessment of how well it has discharged its assigned responsibilities. The committee should also indicate in its report to shareholders whether it has:

- Reviewed and discussed the audited financial statements with management.
- Discussed with the independent auditor those matters required to be communicated in accordance with generally accepted auditing standards (GAAS).
- Received from the independent auditor the independent disclosures and discussed with the independent auditor the matters relevant to auditor independence.
- Recommended to the company's board of directors, based on discussions with management and the independent auditor, that audited financial statements be included in the annual report on Form 10-K or Form 10-KSB be filed with the SEC.

Discussion Questions

1. To be effective, the compensation committee should be independent. Is the given statement true or false? Substantiate your answer.

The compensation committee is responsible for establishing director and executive pay. Thus, if the committee were not independent from management, the committee members might be motivated to increase management compensation above levels that would have otherwise been stipulated.

2. Discuss the common-sense executive compensation program.

The program consists of salary, annual bonus, long-term equity compensation, severance, and disclosure recommendations designed to protect the interest of shareholders.

- Salary—The CEO's salary should be based on the mean of salaries paid at peer group companies, not exceeding $1 million annually, and no senior executive can be paid more than the CEO.
- Annual bonus—The annual bonus paid to senior executives should be linked to performance determined based on both quantitative (financial) and qualitative (nonfinancial) measures as a percentage of salary capped at 100 percent.
- Long-term equity compensation—Long-term equity compensation to senior executives should: (1) be in the form of restricted shares, not stock options; (2) be based on justifiable performance criteria and challenging performance benchmarks; (3) contain a vesting requirement of at least three years; (4) require executives to hold all shares awarded under the program for the duration of their employment; and (5) ensure that the value of a restricted share grant does not exceed $1 million on the date of the grant.
- Severance—The maximum severance payment to a senior executive should be capped at one year's salary and bonus.
- Disclosure—Key components of the executive compensation plan should be specified in the compensation committee's report to shareholders.

3. Explain the key features of an effective succession planning process.

(1) a continuous process; (2) proper oversight and approval by the board; (3) CEO input, involvement, and collaboration as appropriate without dominating the committee; (4) an easily executable and adaptable procedure in the event of a crisis; (5) succession requirements aligned with the company's strategic plans; (6) aims to find the right leader at the right time; (7) the development of talent pools at lower levels; (8) a program in place to identify and professionally develop internal candidates; and (9) avoidance of a "horse race" mentality that may lead to loss of key deputies upon the appointment of the new CEO.

4. Explain the views of executive compensation. Which one do you agree with? Why? Express your views on reasons for higher compensation for CEOs.

Answers may vary. Academic studies present two distinct views on executive compensation. The dominant view is that the design of an optimal compensation package may encourage management to enhance long-term shareholder value. The second view is that executives have considerable influence over the design and amount of their own pay, thus enabling them to extract rents. This suggests there is no relationship between executive compensation and performance primarily because managerial power determines executive compensation. Higher compensation for CEOs may be implemented to attract well-qualified, motivated individuals to run the company. Such compensation, however, may be viewed as excessive by shareholders and other stakeholders.

5. The text lists the characteristics that define a good director. Do you agree with these? Would you add any other characteristics? Defend your answer.

Characteristics of a good director include the ability to: (a) ask the difficult questions; (b) work well with others; (c) utilize industry experience and awareness; (d) provide valuable input; (e) be available when needed; (f) be alert and inquisitive; (g) use business knowledge; (h) contribute to committee work; (i) attend meetings; (j) speak out appropriately at board meetings; (k) prepare for meetings; (l) make long-range planning contributions; (m) provide overall contributions; (n) assure responsibility and accountability; (o) learn about emerging corporate governance reforms and applicable regulations; (p) communicate effectively with all corporate stakeholders; and (q) support the company's economic, ethical, social, and environmental measures. Answers will vary on whether these characteristics are agreed with, or if any additional characteristics would be added. While this list may not be comprehensive, it does detail several of the characteristics of good directors.

6. Search the library or Internet for the text of Sarbanes-Oxley. What does it require regarding the audit committee?

The Sarbanes-Oxley Act of 2002 extended audit committee responsibility and defines this responsibility as oversight of financial reporting and accounting processes of the company, and financial statement audits of the company. Section 301 of SOX also holds the audit committee directly responsible for hiring, firing, compensating, and overseeing the audit work of external auditors. A summary of SOX may be found online at fmcenter.aicpa.org/Resources/Sarbanes-Oxley+Act/Summary+of+the+Provisions+of+the+Sarbanes-Oxley+Act+of+2002.htm, while the full text may be found at sec.gov/about/laws/soa2002.pdf.

7. Briefly discuss the reasons that the audit committee needs effective working relationships with the board of directors, management, internal auditors, and the external auditors.

The audit committee assists the board of directors in fulfilling its responsibilities by bringing specialization and expertise to the board in the areas of financial reporting, internal controls, risk management, and audit activities. As an independent committee of the board of directors, the audit committee must ensure that organizational oversight is successful. Senior executives should inform the audit committee of significant events and transactions that substantially affect the company's risk appetite, and thus management must be able to communicate successfully with the audit committee. The audit committee is responsible for hiring, overseeing, compensating, and firing the head of the internal audit department, and internal auditors are ultimately accountable to the audit committee. This aids in creating robust corporate governance. Open and candid communication between the audit committee and external auditors should preserve the independence of external auditors and better enable the audit committee to discharge its oversight responsibilities. Therefore, an effective working relationship with the external auditors is also necessary to improve organizational oversight.

8. Listing standards require that audit committees be composed solely of independent directors. Do you agree or disagree with this? Why?

Recent corporate governance reforms have promoted director independence as the most important attribute to improve committee effectiveness. In the pre-SOX period: (1) audit committee members were not totally independent, with a significant portion of "grey" directors; (2) independent audit committee members were most likely to support the auditor's position; and (3) there was a positive relationship between audit committee independence and the proportion of outside directors, suggesting that the independence of committee members was largely affected by the independence of the board of directors. Audit committee independence can induce substantial benefits in terms of: (1) improving the quality of financial reports by assisting in reducing financial reporting problems; (2) increasing interactions with internal auditors; and (3) improving the quality of financial statement audits by engaging higher quality auditors.

9. Best practices recommend ten audit committee principles. Identify five that you agree or disagree with and explain your reasoning.

Answers will vary. The ten audit committee principles identified by the author include: (1) formation; (2) independence; (3) member qualifications; (4) authority; (5) funding; (6) oversight function; (7) accountability; (8) charter; (9) agenda; and (10) orientation, training, and continued education. These audit committee principles provide guidance designed to promote effective and efficient audit committees.

True or False

1. A special committee of independent directors may be formed to conduct an independent investigation if director and officer wrongdoings are alleged.
2. The number and size of board committees depend on the number of directors on the company's board.
3. The nominating committee is responsible for establishing director and executive pay designed to set compensation contracts that retain good directors and managers while motivating optimal performance that creates shareholder value.
4. To be effective, the compensation committee should be independent from management.
5. The remuneration of nonexecutive directors should be determined by the chair of the board and executive directors.
6. Finance committee responsibilities include developing, approving, monitoring, and disclosing the company's executive pay philosophy.
7. A proper evaluation process selected by the compensation committee to assess the performance of directors does not depend on the independence of the board from the CEO and corporate governance structure.
8. The purpose of executive evaluation is to identify areas of concern and poor executive performance.
9. Long-term equity compensation to senior executives should be in the form of stock

options.

10. The dominant view is that the executives have considerable influence over the design and amount of their own pay, which enables them to extract rents.
11. The governance committee is usually responsible for identifying, evaluating, and nominating a new director to the board.
12. The move toward majority voting for the election of directors has received a tremendous amount of attention and support from institutional investors on the grounds that it will make the corporate board more accountable to and representative of shareholders.
13. Although the directors' positions on the board are not tenured, there are usually no term limits in the bylaws.
14. Key features of an effective succession planning process include that the majority of directors are independent and do not have financial or personal ties to management.
15. In a situation when the company's CEO is also serving as the chair of the board of directors, an outside directors' committee can be formed to maintain the board's independence.
16. Audit committees are nonessential participants in corporate governance due to decreased fiduciary and accountability responsibilities.
17. The audit committee charter should provide the audit committee with primarily management duties and responsibilities.
18. The audit committee can be described as a client to the external auditor.
19. Audit committees are effectively "one-size-fits-all" entities.
20. The audit committee should be ultimately accountable to the board of directors as representative of all stakeholders particularly shareholders.
21. The audit committee can have no more than three members.
22. A key responsibility of the audit committee is to oversee the financial reporting process and internal controls.
23. The SEC rules regarding audit committee duties are designed to provide the committee with more influence in managerial decisions regarding strategic planning.
24. A whistleblower program is one designed to allow individuals to safely and confidentially inform the audit committee and board of directors of potential financial malfeasance.
25. The audit committee is only required to meet once a year and can perform all required duties in that meeting.
26. Sarbanes-Oxley states, "the company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee."

True or False

1. True
2. True
3. False
4. True
5. True
6. False
7. False

8. True
9. False
10. False
11. False
12. True
13. True
14. False
15. True
16. False
17. False
18. True
19. False
20. True
21. False
22. True
23. False
24. True
25. False
26. False

Multiple Choice Questions

1. Which of the following is not among the three board committees required by the listing standards of national stock exchanges?
   a. Audit committee.
   b. Nominating committee.
   c. Finance committee.
   d. Compensation committee.

2. Which of the following committees approves management strategic plans?
   a. Governance committee.
   b. Audit committee.
   c. Compensation committee.
   d. All of the above.

3. The minimum number of board members on certain committees as suggested by the SEC and required by some professional organizations is:
   a. Two.
   b. Three.
   c. Four.
   d. None of the above.

4. The board committee with the responsibility of approving the company's policy for authorizing claims for expenses from the CEO and other executives is the:
   a. Audit committee.
   b. Compensation committee.
   c. Nominating committee.
   d. None of the above.

5. **Of the following, which are criteria used by the compensation committee for the evaluation of directors when determining and reevaluating director**

compensation and benefits?

a. Knowledge, experience, maturity, objectivity, independence, and expertise.
b. Teamwork, leadership, and ability to set an appropriate tone at the top in promoting ethical conduct.
c. Understanding of the company's business and industry including legal and financial literacy.
d. All of the above.

6. The common-sense executive compensation program should include all of the following components except:

a. Annual bonus.
b. Severance.
c. Long-term equity.
d. Performance.

7. The U.K. Combined Code recommends all of the following major concepts of share-based incentive plans except:

a. Payouts or grants under all incentive plans should be linked to performance measures reflecting the company's objectives.
b. Shareholders should approve any proposed long-term incentive plans.
c. Grants under incentive plans should normally be phased rather than awarded in one block.
d. Vesting of awards should be conditional on meeting the company's specified performance measures.

8. Which of the following is a function of the nominating committee?

a. Reviewing the performance of external auditors and assisting in the implementation of the audit plan.
b. Reviewing the performance of current directors and assessing the need for new directors.
c. Establishing methods and procedures for implementation of a whistleblower program.
d. All of the above.

9. Which of the following would be considered a key feature of an effective succession plan?

a. CEO input, involvement, and collaboration as appropriate without dominating the committee.
b. Easily executable and adaptable procedure in the event of a crisis, aimed at finding the right leader at the right time.
c. The development of talent pools at lower levels.
d. All of the above.

10. According to the author, which of the following is not among the often required types of committees to be established by any company?

a. Governance committee.
b. Nominating committee.
c. Finance committee.
d. Compensation committee.

11. Which of the following committees approves management strategic plans:

a. Governance committee.

b. Nominating committee.
c. Special committee.
d. Audit committee.

12. Which of the following criteria are not used by the compensation committee in the evaluation process:

a. Value-added contribution to the company.
b. Teamwork and leadership.
c. Maturity and objectivity.
d. Director's oversight function.

13. Effective oversight functions of audit committees contribute to:

a. More effective corporate governance.
b. A reliable reporting process.
c. Credible audit functions.
d. All of the above.

14. The "tone at the top" promotes all of the following ideals except:

a. Ethical conduct.
b. Unlawful behavior.
c. Professional accountability.
d. Personal integrity.

15. The audit committee works with which of the following board committees to fulfill the board's fiduciary duties to shareholders and stakeholders:

a. Entertainment.
b. Compensation.
c. Travel.
d. None of the above .

16. What is the relationship between the external auditor and the audit committee?

a. The external auditor is hired, fired, and overseen by the audit committee.
b. The audit committee assembles the compensation package for the external auditor and should approve all audit services.
c. External auditors are held accountable to the audit committee, evaluate the effectiveness of the audit committee, and consider ineffective audit committees as material weaknesses in internal control.
d. All of the above.

17. All members of the audit committee should be financially literate with one member designated as a financial expert. This requires that one member has all of the following except:

a. An understanding of GAAP and financial statements.
b. Experience preparing or auditing financial statements.
c. Knowledge of how to make money in the stock market.
d. Experience with internal controls and procedures for financial reporting.

18. The audit committee is granted which of the following authoritative powers?

a. The authority to hire, fire, and compensate management.
b. The authority to engage independent counsel and other advisors.
c. The authority to conduct any investigations deemed necessary to cover up fraud.
d. All of the above.

19. Which of the following statements is incorrectly stated as a determinant of an effective audit committee?

a. All members of the audit committee should be financially literate and at least one member should be designated as and meet the requirements of a financial expert.
b. Members of the audit committee should be held personally liable for actions causing corporate damages that were in accordance to their fiduciary duties of obedience, due care, loyalty, and fair disclosure.
c. The audit committee should have open and candid communications with management, the board of directors, internal auditors, legal counsel, and external auditors.
d. The audit committee must have adequate financial resources to pay the audit fee, hire advisors to fulfill its oversight functions, and have access to management, internal auditors, and external auditors.

20. The audit committee should be composed of independent, nonexecutive, outside directors. Independence is characterized by the SEC as:

a. Not receiving any compensation from the company other than that as a board member.
b. Not having been employed by the company or its affiliates within the past five years.
c. Not having been a member of the immediate family of the company's executives or its affiliates within the past five years.
d. All of the above.

21. Members of the audit committee should exhibit all of the following characteristics except:

a. Lack of trust and confidentiality.
b. Sufficient financial reporting understanding.
c. Commitment in terms of time and effort.
d. Independence, integrity, and objectivity.

22. All of the following are responsibilities of the audit committee except:

a. Overseeing the financial reporting process and internal controls.
b. Hiring, firing, compensating, and overseeing the audit work of external auditors.
c. Ensuring the company meets or exceeds estimated quarterly earnings.
d. Preapproving all services provided by the independent auditor to the company or its subsidiaries.

23. Which of the following is not a mandatory audit committee report?

a. Reports or minutes of its meetings to the company's board of directors.
b. Formal quarterly report to the company's shareholders and board of directors.
c. Formal annual report to the company's shareholders and board of directors.
d. All of the above are mandatory audit committee reports.

Multiple Choice Questions

1. c.
2. a.
3. b.
4. b.
5. d.
6. d.
7. d.
8. b.
9. d.
10. c.
11. a.
12. d.
13. d.
14. b.
15. b.
16. d.
17. c.
18. b.
19. b.
20. d.
21. a.
22. c.
23. b.

Chapter 6

Review Questions

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. Section 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:
   a. CEO.
   b. CFO.
   c. Controller.
   d. All of the above.

2. Which of the following is/are responsible for promoting effective functioning, ethical conduct, and professional behavior throughout the company?
   a. CEO.
   b. Management.
   c. Board of directors.
   d. All of the above.

3. CEO pay is negatively related to skill when:
   a. There is no large shareholder to monitor management.
   b. The CEO has been paid largely in options and stocks.
   c. The firm has a large shareholder.
   d. None of the above.

4. Which of the following is/are special retirement arrangements made available to senior executives?
   a. Deferred compensation plans.
   b. Supplemental retirement plans.
   c. Retirement packages.
   d. All of the above.

5. **Section 302 executive certification is signed by**:
   a. CFO.
   b. CEO.
   c. Both the CEO and CFO.
   d. Neither the CFO nor the CEO.
6. **According to Section 302, CFOs and CEOs are responsible for:**
   a. Establishing and maintaining the company's disclosure controls and procedures.
   b. Assessing the effectiveness of the company's disclosure controls.
   c. Presenting in the MD&A their conclusions about the effectiveness of disclosure controls and procedures.
   d. 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:**
   a. Earnings management incentives.
   b. Stock price incentives.
   c. Regulatory incentives.
   d. Insider trading incentives.
8. **Incentives for earnings management can be related to which of the following:**
   a. Regulatory incentives.
   b. Market incentives.
   c. Both (a) and (b).
   d. Neither (a) nor (b).
9. **Which of the following is not a feature of a high-quality financial report?**
   a. Relevance.
   b. Usefulness.
   c. Reliability.
   d. 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.**
   a. 5 years.
   b. 2 decades.
   c. 10 years.
   d. 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?**
   a. The nature and purpose of the company's off–balance sheet arrangements.
   b. The relevance and importance of the identified off–balance sheet arrangements reasonably likely to result in a termination or material reduction.
   c. The likelihood of any known event, demand, commitment, trend, or uncertainty.
   d. 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:**
   a. 12 months.

b. 8 months.
c. 9 months.
d. 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?

a. Section 401.
b. Section 409.
c. Sections 401 and 409.
d. 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?

a. Section 404.
b. Section 302.
c. Section 401.
d. Section 409.

15. The effectiveness of ERM depends on:

a. The adequacy and effective functioning of its components.
b. Reporting and compliance.
c. The variety of electronic representational media available.
d. The assessed level of inherent risk of a corporation.

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

a. Aligning risk appetite and strategy.
b. Enhancing risk response decisions.
c. Reducing operational surprises and losses.
d. Decreasing deployment of capital.

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

a. Risk response.
b. Risk assessment.
c. Internal environment.
d. 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?

a. Working with the audit committee and management.
b. Providing assurance on financial information used by the company's management.
c. Participating in the development of nonfinancial measures with other participants in the financial reporting process (e.g. customers, suppliers).
d. 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.

<u>Chapter 7</u>

<u>Review Questions</u>

1. **Explain the categories of the fundamental provisions of the Sarbanes-Oxley Act of 2002.**
    - Corporate governance.
    - Financial reporting.
    - Audit functions.
    - Federal securities law enforcement.
    - Others (e.g., legal counsel, financial analysts).
2. **Explain the financial reporting provisions of SOX and SEC-related rules.**
    - Certification of financial statements and internal controls by CEOs and CFOs.
    - Disclosure of off–balance sheet transactions.
    - Disclosure pertaining to the use of non-GAAP financial measures.
    - Disclosure of material current events affecting companies.
    - Mandatory internal control reporting by management.
    - A study of principles-based accounting standards.
    - Convergence of accounting standards.
        - Recognition of adequate funding for the FASB as an accounting standard-setting body.
    - Oversight function of the FASB by the SEC.
3. **What is one fundamental objective of SOX?**
    One of the fundamental objectives of SOX is to restore investor confidence in corporate America, its financial reporting, and capital markets by enhancing the reliability and integrity of audit functions and the audit process as well as the credibility of audit reports.
4. **Explain the Fair Funds Provision of SOX.**
    It empowers the SEC to obtain civil penalties resulting from enforcement cases and add them to disgorgement funds to compensate investors who suffer losses due to securities law violations.

5. **What are the four divisions of the SEC?**
    - The Division of Corporate Finance.
    - The Division of Market Regulation.
    - The Division of Investment Management.
    - The Division of Enforcement.
6. **Explain the blackout period.**
    The blackout period is defined as any period of more than three consecutive trading days during which the ability of at least 50 percent of the participants or beneficiaries of the company's account plans to trade (purchase, sell, acquire, or transfer) any equity security of the plans is temporarily suspended by the company or by a fiduciary of the plans.
7. **Explain the composition of the PCAOB.**
    The PCAOB functions under SEC oversight, consisting of five members where two of them are certified public accountants (CPAs), chaired by a member who has not practiced as a CPA for at least five years prior to appointment.
8. **What is SAS No. 99 and what are its requirements?**
    SAS No. 99 titled *Consideration of Fraud in a Financial Statement Audit* provides risk factors broken into the fraud pyramid of incentives/pressures, opportunities, and attitudes/rationalizations. SAS No. 99 states that "absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud." SAS No. 99 requires auditors to:
    - Approach every audit with professional skepticism.
    - Discuss among the audit team members regarding the risks of material misstatement due to fraud.
    - Identify fraud risk and management incentives, opportunities, and ability to rationalize occurrence of fraud.
    - Design audit tests responsive to the risks of fraud.

    SAS No. 99 requires that auditors place an increased emphasis on discovering financial statement fraud.
9. **What are some of the advantages of complying with SOX?**
    The mentioned benefits of compliance with SOX in the order of importance are: (1) stronger internal controls; (2) improved accountability of individuals involved in operations and financial reports; (3) reduced risk of financial statement fraud and better fraud safeguards; (4) reduced errors in financial operations and financial statements; (5) improvements in the accuracy of financial reports; (6) empowerment of boards of directors, particularly audit committees; and (7) enhancements of investors' view of public companies.
10. **What is the objective behind cooperation and coordination of the SEC and CESR?**
    - Identify and address emerging risks in the EU and U.S. markets at an early stage.
    - Discuss potential regulatory projects to facilitate converging ways of addressing common issues.
    - Set priorities for discussion and collaboration between the two bodies including market structure issues, the role and responsibility of credit rating agencies and analysts, and mutual fund regulation.

11. Explain the role of courts in corporate governance. Also explain the two views on the role of courts.

The role of courts in corporate governance and corporate internal affairs is determining and interpreting fiduciary duties of its participants, particularly directors and officers.

- The contractarianists view the corporations as a nexus of contracts that establishes a set of private contractual relationships among all corporate governance participants including providers of capital and services.
- Anticontractarianists argue that a corporation is not a typical contract subject to extensive government regulation and view the corporation as a concession of the state.

Discussion Questions

1. **What do you think about this perception that the majority of corporate executives believe that the emerging corporate governance reforms, including SOX, provide standards and measures for corporate compliance, but there is no adequate training, education, or standards for individuals who carry out compliance? Substantiate your answer.**

   Regulators understand that provisions cannot be too exhaustive, due to the dynamic nature and diversity of the many public companies under such provisions. As corporate governance reforms continue to follow a more principles-based approach to regulation as opposed to a rules-based approach, organizations should consider adopting some of the corporate governance best practices outlined by the Conference Board, American Law Institute, American Bar Association, and institutional investors. Adopting corporate governance best practices may aid an organization to comply with various corporate governance reforms. In addition, corporate executives may find it beneficial to engage the services of outside counsel to comply with reforms. These two measures may allow the organization to understand various provisions, and therefore be able to comply more adequately with those provisions.

2. **"The recent wave of financial scandals indicates that regulators are often slow in responding to those scandals, bringing enforcement actions against corporate wrongdoers, and preventing widespread effects of aversion towards the scandal." Do you agree with the given statement? Why?**

   Regulators are often slow in responding to corporate scandals because of the political and regulatory bureaucratic process involving these scandals. In these situations, the state attorney general can be very effective in the early investigation of corporate wrongdoing. For example, the timely activities of New York Attorney General Eliot Spitzer had a significant impact on the mutual fund industry and its operations. Typically, following the announcement by Spitzer regarding possible investigation, the concerned companies would agree to pay fines for bad practices and correct their operations (e.g., 2002 Merrill Lynch analysts' practices). Spitzer's investigation into the mutual fund industry began in late 2003, but it was not until early 2004 that the SEC issued independence rules for mutual funds that were subsequently appealed by the industry. Congress then requested that the SEC revisit its mutual fund rules.

3. **Do you feel the concept of best practices helps the effectiveness of corporate governance? Explain how.**

   Best practices can be used as benchmarks to determine the best way to improve business processes and corporate governance by following the means by which leading organizations achieve excellence performance. Corporate governance may become more robust as a result of the adoption of best practices designed to improve corporate governance structure and operation.

4. **Can SOX and other corporate governance provisions be beneficial for nonpublic companies even though they are not obligated to comply with such provisions? Explain your answer.**

   SOX and other corporate governance provisions can be very beneficial to private companies that have no intention of going public. Furthermore, SOX has become so pervasive that many stakeholders of private companies demand that they conform to some of the provisions of SOX. Some of the less cumbersome provisions of SOX relevant to nonpublic companies are: (1) improving their corporate governance by creating an appropriate balance of power-sharing between owners, management, and auditors; (2) improving the quality of their financial reports; (3) strengthening their code of business conduct; (4) prohibiting loans to their officers; (5) enhancing their communications with their shareholders and other constituencies through holding conference calls, meeting with them, or distributing periodic quarterly and annually financial statements; (6) increasing the effectiveness of the board oversight function through establishing an independent audit committee to oversee financial reporting, internal controls, and audit activities; and (7) improving their ICFR by implementing some of the key provisions of SOX 404 including internal control reports by management and audit reports by the independent auditor.

5. **How do companies encourage compliance with rules and regulations established by regulatory bodies within the corporate governance structure?**

   Companies should comply with comprehensive, transparent, and fair rules, regulations, and standards; enforce these rules, regulations, and standards; and impose equitable penalties for their violations. An effective compliance function reduces incentives for misconduct, reduces conflicts of interest, and encourages ethical and professional conduct.

6. **How does the regulatory and legal environment of a country shape the corporate governance structure?**

   When market correction mechanisms are ineffective, government intervention is necessary. Government intervention can be endorsed on several levels: local, regional (state), and federal (in all three branches: executive, judicial, and legislative). A country's regulatory and legal environment shapes how these reforms are mandated.

7. **Describe the impact of regulatory conflicts and overload on the long-term attractiveness and global competitiveness of the U.S. capital markets.**

   The U.S. approach to corporate governance is regarded as a regulatory-led system that provides high standards of protections for investors influenced by policy makers, regulators, stock exchange listing standards, and state law. These regulations must be cost-effective, efficient, and scalable to promote best practices of corporate governance. Any regulatory conflicts or overregulations can significantly increase compliance costs, have detrimental effects on the long-term attractiveness of U.S. capital markets, and put the markets at a global competitive disadvantage. For foreign companies, with a low number of U.S. equity shareholders, the compliance costs with strict regulations can outweigh the benefits of listing on U.S. capital markets and cause these companies to deregister.

True or False

1. Section 1103 of SOX authorizes the SEC to obtain a temporary order to escrow extraordinary payments by the company to its directors and officers.
2. One of the goals of the SEC is to foster informed investment decision making.
3. The Division of Corporate Finance establishes and maintains standards for fair, orderly, and efficient capital markets.
4. The rules established by the SEC do not have a significant impact on the corporate governance structure of public companies, but do have an impact on that of the private companies.
5. The SEC does not have any powers to bring civil enforcement actions against the individuals who violate its rules and securities laws.
6. The SEC requires each of the self-regulatory organizations (SROs), including the NYSE and Nasdaq, to review the adequacy of their governance practices.
7. The PCAOB does not have any powers to investigate registered public accounting firms and their personnel for potential violations of applicable laws, rules, and regulations.
8. The U.S. Sentencing Commission (USSC) guidelines have been used by companies as a benchmark for reducing the risk of significant penalties if a violation of a law occurs.
9. The SEC requires mutual funds to establish certain governance practices.
10. Investment protection principles (IPPs) do not require broker/dealers who trade securities on the fund's behalf to establish a monitory process to ensure compliance with the IPPs.
11. IPPs require investment managers to disclose the amount of commission paid to broker/dealers.
12. Courts play a role in corporate governance by interpreting implications and applicability of corporate governance measures.
13. One corporate governance recommendation is that the board of directors should develop a structure that establishes an appropriate balance of power-sharing between the CEO and the independent directors.

14. Shareholder activism can increase agency costs by promoting effective corporate governance principles and monitoring compliance with corporate governance best practices.

True or False

1. True
2. True
3. False
4. False
5. False
6. True
7. False
8. True
9. True
10. False
11. True
12. True
13. True
14. False

Multiple Choice Questions

1. The primary focus of SOX was to improve the _________ of public financial reports.
   a. Reliability.
   b. Quality.
   c. Transparency.
   d. All of the above.

2. The PCAOB functions under the SEC oversight consist of:
   a. Two CPAs, chaired by a member who has not practiced as a CPA for at least five years prior to appointment.
   b. One CPA, chaired by a member who has not practiced as a CPA for at least five years prior to appointment.
   c. No CPAs, but chaired by a member who has not practiced as a CPA for at least five years prior to appointment.
   d. None of the above.

3. PCAOB governance, budget, and operations are designed in such a manner to maintain its:
   a. Dependence on public accounting firms and the federal government.
   b. Independence from public accounting firms and the federal government.
   c. Either independence or dependence on public accounting firms and the federal government.

d. Neither independence nor dependence on public accounting firms or the federal government.

4. The PCAOB is authorized to register:

a. Only U.S. public accounting firms auditing U. S. public companies.

b. Only non-U.S. public accounting firms auditing U.S. public companies.

c. Both U.S. and non-U.S. public accounting firms auditing U.S. public companies.

d. Neither U.S. nor non-U.S. public accounting firms auditing U.S. public companies.

5. **Inspection reports including violations may be made available to the public if concerns and issues included in the reports are not properly addressed by the accounting firm within:**

a. 6 months after the date of the inspection report.

b. 12 months after the date of the inspection report.

c. 10 days after the date of the inspection report.

d. Immediately after the date of the inspection report.

6. By launching its new accounting culture, the AICPA plays which of the following roles:

a. A standard-setting role.

b. A fraud prevention and detection liaison role.

c. An educational role.

d. All of the above.

7. **The FASB has been criticized for which of the following:**

a. Being too slow to respond to emerging changes in the business environment.

b. Developing broad accounting concepts.

c. Providing standards for financial reporting.

d. Providing guidance on the implementation of standards.

8. The primary responsibility of the CESR is to:

a. Issue standards and guidance.

b. Promulgate standards.

c. Issue implementation guidance.

d. All of the above.

9. Which of the following is/are the duty/duties of the SEC:

a. Enforce rules and laws.

b. Interpret federal securities laws.

c. Both (a) and (b).

d. Neither (a) nor (b).

10. The investment protection principles require broker/dealers who trade securities on the Fund's behalf to:

a. Sever the link between compensation for analysts and investment banking.

b. Prohibit investment banking contribution (input) into analyst compensation.

c. Establish a review committee to approve analysts' research recommendations.

d. All of the above.

11. The effectiveness of corporate governance depends on:

a. Compliance with state and federal statutes.

b. Compliance with listing standards.

c. Compliance with best practices recommended by investor activists and professional organizations.
d. All of the above.

12. Institutional investors may not fully exercise their corporate governance oversight function and monitoring controls because:

a. Pension fund managers are typically the ultimate beneficiaries of the wealth generated by corporations.
b. They may have strong incentives to engage in monitoring of the company's affairs.
c. Such monitoring engagements are with costs.
d. Fund managers may be reluctant to incur these monitoring costs.

Multiple Choice Questions

1. d.
2. a.
3. b.
4. c.
5. b.
6. d.
7. a.
8. d.
9. c.
10. d.
11. d.
12. d.

Chapter 8

Review Questions

1. What are the recommendations made by the IIA to the SEC and the PCAOB in improving the effectiveness of Section 404 compliance?

- Consideration of the importance of enterprise-wide risk management in improving corporate governance rather than just ICFR.
- More-detailed guidance regarding management's assessment of internal controls.
- More-detailed guidance on the quarterly Section 302 management assessment process and reporting on management corrections of reported material weaknesses.
- Clarification of "principal evidence" and additional guidance regarding key issues such as a vigilant board of directors and management overrides.
- Increasing the cost effectiveness of compliance with provisions of SOX by clarifying SEC implementation rules and providing better communication between the audit committee, external auditors, and management.
- Creation of appropriate balance between the focus on compliance with Section 404 and other enterprise-wide risks affecting all aspects of corporate governance.

2. What does the Conference Board recommend regarding the establishment of an internal audit function in an organization?

All public companies should have an internal audit function.

3. Why is the establishment and maintenance of an internal audit function crucial to the effectiveness of a company's corporate governance in achieving its goal of creating shareholder value and protecting stakeholder interests?

The internal auditors add value and improve an organizations' governance. The Sarbanes-Oxley Act, SEC related-rules, listing standards, and professional organizations all directly or indirectly recognize the important role of the internal audit.

4. What are the areas in which SEC rules permit internal audit outsourcing to the client's independent auditor?

- Operational internal audits that are not related to internal accounting controls, financial systems, or financial statements.
- Nonrecurring assessment of discrete items or other programs unrelated to outsourcing of the internal audit function.

5. What are the factors to be considered by the internal auditors when supporting and consulting management to comply with Section 302 and 404?

- Consulting management on internal control activities compliance does not impair the internal auditor's independence and objectivity.
- Making key management decisions in the compliance process impairs the internal auditor's objectivity and independence.
- Having responsibility for specific operations or participation in directing key management decisions impairs the internal auditor's objectivity and independence.
- The design, implementation, and drafting procedures for internal controls to comply with Sections 302 and 404 impair the internal auditor's independence and objectivity.
- Recommendation of standards for internal controls or review of internal control procedures does not impair the internal auditor's objectivity and independence.
- Devoting a significant amount of effort to consult with management on Sections 302 and 404 compliance can deplete internal auditors' resources and deviate their attention from other value-adding activities.

6. Explain the steps involved for the establishment or improvement of an effective internal audit function.

- Appoint the right person to be the chief audit executive (CAE)**.** The audit committee of the board of directors is directly responsible for the appointment, compensation, and, when necessary, the dismissal of the company's CAE.
- Establish a written audit charter. The internal audit charter should specify the purpose, authority, and responsibility of the internal audit function as an integral component of corporate governance in adding value to the company's sustainable performance.
- Develop an audit strategy. The internal audit function should have a sound audit strategy that adds value to the company's operations in risk management, financial reporting, internal controls, and governance processes.

- Implement the audit strategy. Effective implementation of the internal audit strategy requires proper audit plans, sufficient resources including ethical, highly specialized, and competent staff, commitment from senior management, and approval of the audit committee.
- Establish quality assurance and performance evaluation. To ensure a high-quality internal audit function it should be evaluated annually.

7. Discuss the responsibilities of the internal audit function.

The internal audit function is responsible for providing assurance that the company's operations, risk assessment, internal controls, financial reports, and governance processes as designed and implemented by management are adequate and effective to ensure:

- Management operations are efficient.
- Both operational and financial risks are identified, managed, and monitored.
- Proper communication and interactions exist between all corporate governance participants.
- Key operational, managerial, and financial information is accurate, timely, and reliable.
- The company is in compliance with applicable laws, regulations, rules, and standards.
- Employees adhere to internal policies as well as external regulations.
- Resources are safeguarded and used efficiently.
- Managerial programs, plans, and objectives are effectively achieved.
- The internal audit function uses appropriate risk-based audit methodology.
- The established annual audit plan is effectively implemented.
- A professional internal audit staff is maintained with adequate skills, knowledge, education, certification, and experience.
- An appropriate quality assurance program is established to assess the effectiveness of the internal audit function.
- A continuous improvement process is implemented.
- External and internal audit activities are properly coordinated to ensure adequate coverage and prevent duplication.
- Codes of corporate ethics are complied with.
- The audit committee receives periodic reports on internal audit activities and significant financial and internal control processes.

8. Explain the three sets of mandatory standards for Professional Practice of Internal Auditing (SPPIA).

- Attribute standards specifying appropriate features of individual auditors or audit functions performing internal auditing.
- Performance standards regarding the performance of internal audit engagements.
- Implementation standards describing attribute and performance standards and how they can be applied to the specific types of audits.

9. What are the best practices that should be implemented by organizations according to PricewaterhouseCoopers?

PwC suggests that internal auditors' best practices include the following:

- Build an adequate internal audit staff to support the needs of business.

- Structure the internal audit function on a fluid and flexible framework.
- Design an enterprise-with-risk–based audit program.
- Broaden audit scope to address third-party and vendor risk.
- Combat fraud by advocating ethical conduct throughout the organization.
- Manage information systems risk proactively.

10. What purpose does the written audit charter serve for the company?

The internal audit charter should specify the purpose, authority, and responsibility of the internal audit function as an integral component of corporate governance in adding value to the company's sustainable performance.

11. What authoritative rights should be granted to the internal audit function and the CAE?

- Full and free access to the company's audit committee.
- Unrestricted access to the company's records, documents, property, and personnel.
- Authority to determine the scope, nature, extent, and timing of internal audit activities.
- Access to plans that have already been approved by the audit committee.
- Authority to review risk assessment, internal controls, compliance, financial reporting, and governance processes.
- Authority to provide consulting services to corporate governance participants including directors, executives, and key financial personnel.
- Authority to assist the audit committee in its oversight responsibilities relevant to financial reporting and audit activities.
- Authority to discuss initiatives, policies, and procedures regarding risk assessment, internal controls, compliance, financial reporting, and governance processes with management and other corporate governance participants.

Discussion Questions

1. A close working relationship between the audit committee and internal auditors can improve the effectiveness of corporate governance. Do you agree with this statement? Substantiate your answer.

Answers may vary. First, the independence and objectivity of internal auditors can be enhanced when they report their findings directly to the audit committee. The internal audit function should be independent in the sense that auditors maintain their: (1) planning independence in determining scope and audit planning: (2) investigating independence in conducting the audit and performing audit procedures; and (3) reporting independence in communicating audit findings to senior management and the audit committee. Second, the prestige and status of internal auditors can be strengthened when they work with management at all levels. Third, internal auditors have the potential to be a significant source of assistance to the audit committee to effectively fulfill their oversight responsibilities in functions such as financial reporting, internal controls, risk management, external audit, whistleblowing, ethics, and taxes.

2. How can an audit committee contribute to the success and effectiveness of internal auditors and the achievement of their value-adding activities?

By ensuring that internal auditors have:

- Sufficient independence from management by reporting to and being held accountable to the audit committee.
- Adequate resources, competence, and focus to assess the company's internal controls and enterprise risk management.
- Proper knowledge of the company's corporate governance, internal control, financial reporting, and audit activities.
- The mechanisms and confidence to bring forward controversial financial reporting issues.
- A process for communicating directly with the company's audit committee on a regular and timely basis.
- Access to the audit committee to discuss concerns related to management activities, financial reporting risk, and fraudulent financial reporting.

3. In your opinion, why are there no regulations that require internal audit assurance reports?

Answers may vary. Internal auditors provide information to management based on the information needs of executives and decision makers within the organization. If such a process were regulated, then the information provided by internal auditors could become more standardized to comply with applicable laws. This, in turn, could cause such information to be less effective for managers. Thus, regulation in the internal audit process may not be helpful to effective decision making within the organization, especially since regulations are already in place for external reporting and independent audit behavior.

4. In what ways does the internal audit department add value to an organization?

Internal auditors may improve the effectiveness of their organization's governance by assisting management in assessing internal controls and enterprise risk management, identifying their material weaknesses, and making suggestions to management for their improvements.

5. What factors have led to the transformation of the IIA's definition of "internal auditing"? Research your answer.

Internal auditors have made impressive progress during the past several decades. The focus of internal auditing shifted away from appraisal and compliance activity toward objective assurance and consulting activities. There was a shift from "serving management" to "serving the organization" to "corporate governance." The role of internal auditors changed from providing management with input and objective feedback to participating directly in decision making.

6. What are the benefits and negative results of outsourcing the internal audit function?

Answers may vary. Some benefits from outsourcing may include: increased competency of the internal audit function; enhanced independence of internal auditors; and competitive performance from the internal audit firm. Negative results of outsourcing may include: privacy concerns; control over information; lack of flexibility; and lack of positive externalities experienced in other areas of the organization due to in-house internal audit services.

7. The role of internal auditors has evolved from performing traditional appraisal activities and audit functions of evaluating internal controls to being considered an

important component of corporate governance by adding value to organizations by improving operations. Is the given statement true or false? Substantiate your answer.

Answers may vary. Internal auditors now focus on adding value to their organizations in performing a variety of assurance-related functions by providing assistance to: (1) the audit committee in effectively discharging its oversight responsibilities; (2) management in making business decisions, assessing enterprise risk management, certifying internal controls and financial statements, and identifying and preventing problems and potential risks; and (3) the independent auditor in performing their assurance and integrated audit functions. Thus, the given statement is true.

8. Explain how internal auditors' expertise in internal control can ensure effectiveness of the corporate governance structure.

Internal auditors can identify areas within the organization that may need corporate governance improvement, suggest means for improving corporate governance in those areas, and evaluate the efforts of management in improving the effectiveness of corporate governance.

True or False

1. The purpose of performance evaluation is to improve the quality of the internal audit function and provide a basis for promotion, advancement, and compensation.
2. Development and practice aids usually offer training and education on emerging developments in internal auditing consisting of courses, research reports, and continuing education seminars.
3. The internal audit function under the direct oversight of the audit committee is responsible for providing assurance that the company's operations, risk assessment, internal controls, financial reports, and governance processes as designed and implemented by management are adequate and effective to ensure key operational, managerial, and financial information is accurate, timely, and reliable.
4. Independent auditors are prohibited from performing internal auditing outsourcing services for nonpublic company audit clients.
5. The Conference Board recommends that all public companies have an internal audit function.
6. The decision of whether to establish and maintain an internal audit function or outsource the internal audit function should be made by the company's shareholders, audit committee, management, legal counsel, and independent auditor.
7. The internal auditor's role is regarded as a value-adding function to improve managerial and employee performance while preserving their independence and objectivity.
8. Internal audit activities should be viewed as a value-added function within the organization's corporate governance with sufficient resources to carry out their assigned responsibilities.
9. SOX directly addresses internal auditor responsibilities or internal audit functions.
10. The success of corporate governance depends on the effectiveness of all corporate governance functions.

11. Under Sections 302 and 404 of SOX, management is authorized to delegate its responsibilities to the internal auditors.
12. The term “service” mentioned in definitions of internal auditing as provided by the IIA initially in 1947, and subsequently in 1981 and 1999, implies that internal auditing is a line activity rather than a staff within the organization.
13. The majority of U.S. MNCs rated security and privacy, timing and timeliness, control, and ability to deal with compliance issues as important and highly effective in making decisions to outsource financial functions.
14. Value driver identification including gathering information about value drivers of internal audit is the third phase in the four-phase plan suggested by PwC.

True or False

1. True
2. True
3. True
4. False
5. True
6. False
7. True
8. True
9. False
10. True
11. False
12. False
13. True
14. False

Multiple Choice Questions

1. Which of the following is the second step in the process of establishment or improvement of an effective internal audit function?
   a. Establish quality assurance and performance evaluation.
   b. Develop an audit strategy.
   c. Establish a written audit charter.
   d. Appoint the right person to be the CAE.

2. Which of the following statements is true regarding the internal audit functions of a publicly held company?
   a. Listing standards require an internal audit function.
   b. The internal auditor may also be the external auditor.
   c. The internal audit department only reports to the audit committee.
   d. All of the above.

3. Which of the following is not a step in establishing or improving an effective internal audit function?
   a. Establish quality assurance and performance evaluation.
   b. Develop an audit strategy.
   c. Establish a verbal audit charter.

   d. Appoint the right person to be the CAE.

4. **What is the primary purpose of the CAE?**
   a. Effectively supervise and administer the internal audit.
   b. Socialize with the external auditors to ensure positive reporting.
   c. Be the sounding board of the audit committee.
   d. Hire and fire the accounting personnel of the company.
5. **What is found in the audit strategy?**
   a. Scope, nature, procedures, and timing of all internal audit activities.
   b. Procedures and timing of all internal audit activities and the fees associated with the audit.
   c. Scope and nature of all internal audit activities and the fees associated with the audit.
   d. Fees associated with the audit.
6. **The four principles of the IIA code of ethics are:**
   a. Integrity, objectivity, confidentiality, and competency.
   b. Integrity, objectivity, independence, and competency.
   c. Integrity, independence, confidentiality, and authority.
   d. Integrity, objectivity, confidentiality, and independence.
7. **To maintain their independence and objectivity, internal auditors should refrain from:**
   a. Making decisions on behalf of management.
   b. Financial reporting.
   c. Providing consulting services.
   d. Compliance with applicable laws, rules, and regulations.
8. **Which of the following statement does not adequately describe the IIA?**
   a. The IIA is a well-recognized organization representing more than 102,000 members throughout the world.
   b. The IIA is viewed as the national voice of internal auditors through its issuance of the International Standards for the Professional Practice of Internal Auditing.
   c. The IIA has played an important role in improving corporate governance, internal control, and financial reporting.
   d. The IIA has adopted a Professional Practices Framework (PPF) that includes new and updated internal auditing standards.
9. **Which one of the following is not a recommendation issued by the IIA to the SEC?**
   a. The consideration of the importance of enterprise-wide risk management in improving corporate governance rather than just internal control over financial reporting.
   b. More-detailed guidance regarding management's assessment of internal controls.
   c. More-detailed guidance on the quarterly Section 302 management assessment process and reporting on management corrections of reported material weaknesses.
   d. Until all SOX implementation issues have been effectively "ironed-out," there should be a decrease in the communication among management, audit committee, and external auditors.

10. Which of the following is not an element of internal auditing as defined by the IIA?

a. Service.
b. Focus on objectivity.
c. The role of internal auditors.
d. Financial reporting.

11. SOX prohibits independent auditors from performing which services for their client?

a. Financial reporting.
b. Providing certain internal auditing outsourcing activities contemporaneously with audit services.
c. Improving the internal audit function.
d. Establishing and maintaining an internal audit function.

12. Which of the following is not rated as important and highly effective in making decisions to outsource financial institutions?

a. Timing and timeliness.
b. Security and privacy.
c. Ability to deal with compliance issues.
d. None of the above.

13. Audit committees should utilize internal auditor services in fulfilling their oversight responsibilities over:

a. Financial reporting.
b. Internal controls.
c. Audit activities.
d. All of the above.

14. The IIA's 2004 Position Paper suggests which of the following activities of internal auditors to support their company's project to comply with Sections 302 and 404?

a. Project oversight.
b. Consulting and project support.
c. Ongoing monitoring and testing.
d. All of the above.

15. PricewaterhouseCoopers suggests that internal auditors' best practices should include all of the following except:

a. Build an adequate internal audit staff to support the needs of business.
b. Structure the internal audit function on a fluid and flexible framework.
c. Narrow the audit scope to address third-party and vendor risk.

Design an enterprise-with-risk–based audit program.

Multiple Choice Questions

1. c.
2. a.
3. c.
4. a.
5. a.
6. a.
7.a.

8. b.
9. d.
10. d.
11. b.
12. d.
13. d.
14. d.
15. c.

Chapter 9

Review Questions

1. **How can an effective audit function be achieved?**
   An effective audit function is achieved by improving the following:
   - Auditor selection and client acceptance processes.
   - Audit quality and its relation to audit fees.
   - Evidence-gathering procedures.
   - Integrated audit approach.
   - Auditor independence.
   - Audit and nonaudit services.
   - Audit opinion.
2. **Explain the term "expectation gap" in auditing.**
   Expectation gap is the difference between what the investing public and other users of audited financial statements believe the responsibilities of auditors are and what auditors are willing to assume as responsibilities according to their professional standards.
3. **Explain the initiatives to be taken to improve audit quality as well as the transparency of the audit process and report.**
   - Publication of audit engagement letters.
   - Shareholder rights to question auditors.
   - Publication of auditor resignation statements.
   - Lead partner's signature on audit reports.
   - Annual shareholder annual ratification of the audit firm.
4. **What are the structural factors of accounting that provide opportunities for bias to influence judgment?**
   - Ambiguity.
   - Attachment.
   - Approval.
5. **What is the underlying basis of audit firm rotation?**
   To reduce the likelihood of economic ties and friendship with clients, public accounting firms must be rotated and clients must be prohibited from rehiring the accounting firm at the end of the contract for a given period of time.
6. **Explain the "pass/fail" approach utilized by the current auditing model.**

The pass/fail approach states whether financial statements are presented fairly in conformity with GAAP (pass) or not (fail) without providing any information regarding the quality of audited financial statements.

7. What are the three categories in which internal control deficiencies are classified according to Auditing Standard No. 2?

- Inconsequential deficiencies.
- Significant deficiencies.
- Material weaknesses.

8. Explain the different types of opinions on internal control over financial reporting.

- Unqualified opinion—An unqualified opinion can be rendered when there are no identified material weaknesses in ICFR and no scope limitations.
- Adverse opinion—An adverse opinion should be rendered when there are significant deficiencies in the company's ICFR that result in one or more material weaknesses.
- Qualified/disclaimer opinion—A disclaimer of opinion should be given when there is a scope limitation and the auditor cannot express an opinion on management's assessment of the effectiveness of the company's ICFR.

9. What are the four tests used to classify tax planning as aggressive?

- The auditor provides any service related to the plan or opinion.
- The idea was not initiated by the client.
- A significant purpose of the idea was to avoid taxes.
- The plan has a less than 50-50 chance of prevailing if challenged by the IRS.

10. **Explain several of the steps followed by the PCAOB for its inspection process.**

- Selecting the audit clients based on the PCAOB's assessment of the likelihood of material misstatements or significant audit deficiencies.
- Reviewing aspects of the selected audits by each firm.
- Choosing the engagements to review according to the PCAOB's criteria.
- Retraining the accounting firm to limit or influence the engagement selection process or any other aspect of inspection review.
- Reviewing the selected audit clients' financial statements and certain SEC filings.

11. Explain the importance of the inspection report.

- It improves audit effectiveness by identifying and requiring resolution of audit failures.
- It identifies and properly addresses emerging and common accounting and auditing issues.
- It improves the audit firm's system of quality control and evidence-gathering procedures.
- It assists the PCAOB in establishing appropriate auditing, quality control, and ethics standards.
- It enhances public trust and investor confidence in the auditing profession.

12. How are PCAOB enforcement investigations coordinated with those of the SEC?

- The PCAOB staff meets frequently with the SEC staff.

- The PCAOB staff attends SEC testimony of auditors.
- The SEC staff sits in on PCAOB testimony without asking questions.

13. When does the audit committee monitor auditor independence and why?

The committee monitors auditor independence during:

- The appointment process by being directly responsible for hiring, firing, compensating, and overseeing the work of the auditor.
- The planning stages of the audit to ensure that management is not influencing the audit plan or scope of the audit.
- The evidence-gathering phase of the audit to ensure that the auditor has access to all information, records, schedules, and financial statements, and the scope of the audit was not limited.
- The reporting phase to ensure auditor judgment and opinion were not influenced by management or a sense of loyalty to the company.

14. How can the audit committee ensure proper disclosures of auditor independence?

The committee ensures proper disclosures by receiving auditor independence confirmation from the company's independent auditor prior to the filing and distribution of audited financial statements.

15. Explain the term auditor independence and the principles it is based on.

Auditor independence is defined as freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased and objective audit decisions. It is based on three basic independence principles:

- Auditors cannot be part of management or its team.
- Auditors cannot audit their own works.
- Auditors cannot serve in advocacy roles as specified by the SEC.

16. **Explain the dual testing of controls and substantive tests.**

It is an integrated audit approach in which auditors test controls at both the entity-level and the transaction-level along with substantive tests.

17. What are the four aspects of the financial reporting process that are targeted by SOX as needing improvement?

- Misstatements or omissions in financial statements.
- Internal control deficiencies.
- Accounting estimates.
- Fraud.

18. What are the six steps for the effective assessment of company-level controls?

- Engage in gap remediation and continuous improvements.
- Test the effectiveness of company-level controls.
- Document and assess company-level controls.
- Obtain input on the design and operation of company-level controls.
- Build an assessment structure for company-level controls.
- Define the project plan and key milestones.

19. Which three boards in the United Kingdom look after the auditing profession and auditing standards?

- Professional Oversight Board (POB), formerly Professional Oversight Board for Accountancy (POBA).
- Auditing Practices Board (APB).
- Accountancy Investigation and Discipline Board (AIDB).

20. Explain Auditing Standard No. 3: Audit Documentation.

AS No. 3 governs audit documentation by requiring the auditor to prepare and maintain—for at least seven years—audit documentation in sufficient detail to support the conclusion reached in their reports.

21. **What is the PCAOB proposed standard on auditor independence and what circumstances consider auditor independence impairment?**

The PCAOB proposed standard on auditor independence identifies four circumstances that would be considered an impairment of auditor independence when performing tax services for their audit clients. These circumstances are:

- Registered auditors perform tax services on contingent fee arrangements for their audit clients.
- Auditors provide aggressive tax planning.
- Auditors perform aggressive tax shelters.
- Auditors provide tax services to top executives of audit clients.

Discussion Questions

1. "The public trust in auditors' judgments and reputation is vital in regarding the audit function as value-added services that lend credibility to published financial reports." Do you agree or disagree with the given statement? Explain your answer.

The audit function is considered value-added when it lends credibility to published financial statements by reducing the information risk associated with those statements. When auditors provide assurance services, they are providing their opinion by utilizing their professional judgment. Public trust in such a judgment depends on the reputation of the auditor and the firm with which he or she is employed. If the public does not trust the reputation of the firm or the judgment of the auditor, questions may arise regarding the accuracy of the object of assurance. Thus, if the auditor or firm is considered to be untrustworthy, their services may not be considered value-added or helpful to the organization or its stakeholders.

2. According to the author, an auditor has two responsibilities: to express and opine on the true and fair presentation of financial statements in conformity with GAAP, and at the same time, to assess the quality of the reports. Do you feel it is possible for an auditor to discharge both duties? Explain your answer.

This audit function can be achieved by improving the following: (1) the auditor selection and client acceptance process; (2) audit quality and its relation to audit fees; (3) evidence-gathering procedures; (4) the integrated audit approach; (5) auditor independence; (6) audit and nonaudit services; and (7) the audit opinion.

3. Confidence and public trust in auditors have been reduced due the concern that auditors serve the interests of management who write their checks rather than the

shareholders who eventually pay their fees. Do you agree or disagree? Explain your answer.

The wave of financial scandals along with financial restatements by high-profile public companies and related audit failures eroded public trust and investor confidence in financial reports and audit functions. Many concerns have been raised regarding the challenges confronting the accounting profession in the aftermath of these scandals and the related regulatory responses. Since the passage of SOX, the audit committee is responsible for compensating the audit firm rather than management. Hopefully this and other measures will improve corporate governance and thus boost investor confidence and public trust in auditors.

4. **Explain the importance of public accounting firms in a capital market.**

   Auditors attest to the statements of management, within material respects, giving credibility to management's statements and allowing stakeholders to make decisions regarding with reasonably accurate management representations. If the representations of management were not seen as credible, investors and other stakeholders could not rely on information from management. This would lead to inefficient markets and a volatile economy. Thus, the services of public accounting firms are important to the function of the markets and the economy through reducing information risk associated with the information disseminated to the capital markets.

5. **Do you think it is right to eliminate incentives that cause auditor self-serving biases in order to improve the quality of the audit? Substantiate your answer.**

   Eliminating any conflicts of interest the auditor may experience is helpful in improving the quality of the audit. This improves the auditor's objectivity, and also aids in establishing the auditor's credibility. When auditor objectivity is enhanced, the quality of the audit is improved.

6. **Is there any difference between tax planning and abusive tax shelters? Explain your point of view.**

   There is no standard or law defining the term "tax shelter" or differentiating between "tax planning," which is a legitimate means of reducing tax liability, and "abusive tax shelter," which is illegal. Nonetheless, abusive tax shelters are characterized as "transactions in which a significant purpose is the avoidance or evasion of federal, state, or local tax in a manner not intended by the law."

7. **Explain why auditor independence is backbone of the auditing profession**.

   Auditor independence lends credibility to the auditor and maintains a solid reputation for the firm in which he or she is employed. If auditor independence is impaired, the reputation of the auditor and the auditing firm could be placed in jeopardy due to legal actions taken by regulatory bodies against the firm and decreased confidence in audit reports issued by the firm.

8. **Explain how internal auditors are important in performing the integrated audit.**

Effective communication between the audit committee, internal auditors, and other corporate governance participants is an important part of the integrated audit process. The audit committee should meet with the company's CFO, internal auditor, independent auditor, and legal counsel to discuss the integrated audit of annual financial statements, including management's assessment of the effectiveness of ICFR, auditor report on management's assessment, and audit of annual financial statements, to evaluate the overall integrity and quality of financial reports before they are filed or distributed.

9. Do you think auditors are solely responsible for any audit failure? What steps would you, as an auditor, take to ensure that you are minimally blamed for a business failure?

Auditors may not always be solely to blame for audit failures, since unethical behavior and earnings management schemes may sometimes be kept hidden from auditors even when due diligence is used in the audit process. However, sometimes auditors may look the other way when fraud is perpetrated by members of the audited organization. In such cases, the auditors would be responsible for the audit failure. Auditors can practice due diligence and take steps to enhance independence from the client to decrease the occurrence of possible audit failures.

10. "Critics argue that any contractual provisions that limit the external auditor's liability or require waiving the right to a jury trial may have detrimental effects on auditor impartiality, objectivity, and quality." Express your views on the given statement.

Some may argue that auditor liability should be limited on the grounds that such a limitation could protect auditors from the consequences of auditing an organization that has engaged in fraudulent activities or unethical behavior without catching such activity. Others may argue that a limitation of auditor liability would result in decreased audit quality, since the consequences of providing the wrong opinion are lessened.

11. Discuss briefly the steps established by the PCAOB for its inspection process.

The inspection process consists of: (1) selecting audit clients based on the PCAOB's assessment of the likelihood of material misstatements or significant audit deficiencies; (2) reviewing aspects of the selected audits by each firm; (3) choosing the engagements to review according to the PCAOB's criteria; (4) retraining the accounting firm to limit or influence the engagement selection process or any other aspect of inspection review; (5) reviewing the selected audit clients' financial statements and certain SEC filings; (6) selecting certain higher-risk areas for review (e.g. revenue recognition, confirmation); (7) reviewing the selected areas of revenues, reserves or estimated liability, income taxes, related party transactions, derivatives, supervision of work performed by foreign affiliates, internal control assessment and documentation, and risk assessment; (8) analyzing end-of-the year closing and adjusting entries, particularly adjustments that were suggested by the auditor and were not booked by the client; (9) reviewing written communications between the auditor and the client's management; (10) reviewing written communication between the auditor and the client's audit committee; (11) conducting an interview with the chairperson of the audit committee of the selected audit client; (12) discussing unresolved aspects of the inspection process with the personnel from the firm's national offices if the issues cannot be resolved through review of work papers and discussion with the engagement team; (13) selecting additional audits if necessary to follow leads to the root of audit deficiencies (e.g., other audits performed by the same audit partner or engagement team); (14) reviewing other work performed by internal reviewers who missed the reviewed partner's errors; (15) identifying and resolving audit deficiencies and problems early in their development; (16) inviting the public accounting firm to comment on the discovered potential material accounting errors and significant audit deficiencies; (17) discussing the discovered audit problems with audit firm representatives including members of the engagement team, the firm representative responsible for the inspection process, national office experts, the managing partner, or the firm's CEO; (18) addressing audit problems, lack of performing necessary audit procedures, and quality control requirements; (19) disclosing the public portion of the inspection report on the PCAOB Web site; and (20) disclosing the nonpublic portion of the inspection report primarily regarding the firm's quality control system and other PCAOB communication to the audit firm and out of public view unless the firm fails to take proper action to correct the identified audit failures in due time.

12. Explain the importance of auditor independence in the auditing profession and to society and the investing community.

Auditor independence establishes and maintains the credibility of the auditing profession, and instills confidence in the investing community and society regarding the work of audit professionals. Confidence in the work of audit professionals may dwindle if such independence were impaired, calling into question the value-adding nature of such audit services.

13. How do external auditors lend credibility to the corporate governance structure?

The independent auditor assurance function provides reasonable assurance that financial statements are free from material misstatements due to error and fraud, and expresses an opinion on the fair presentation of financial statements in conformity with GAAP. Registered auditors are also required to express an opinion on management's assessment of the effectiveness of the design and operation of ICFR as well as an opinion on the effectiveness of internal control itself. The auditor assurance function is intended to lend credibility to financial reports and reduce information risk that financial reports are biased, misleading, inaccurate, or incomplete.

True or False

1. According to modern company law, effective reporting and accounting are essential for effective governance.
2. The Securities Exchange Act of 1934 requires that companies offering stock to the public in raising capital must have their financial statements audited by an independent public accountant.
3. Corporate governance reforms do not mandate external auditors to be independent.
4. The IAASB defines reasonable assurance as absolute in nature.

5. Technical competencies are considered to be the auditors' knowledge of relevant professional standards, rules, laws, and regulations.
6. Reporting competencies are the auditor's ability to choose appropriate evidence-gathering procedures.
7. When considering the audit function as a value-added service, public trust in auditors' judgments and reputation is very important.
8. One of the primary purposes of corporate governance reforms is to improve the quality and credibility of financial statement audits and audit reports.
9. One of the missions of the CPCAF is to provide leadership through sponsoring public forums and periodic meetings with interested groups.
10. Ethics education is sufficient to have an impact on bias.
11. The nature and extent of management's documentation of internal controls in providing reasonable support for management's assessment plays an important role in performing tests of controls.
12. PCAOB standards allow public accounting firms to provide tax shelter services to their audit clients that impair their independence.
13. Conducting an interview with the chairperson of the audit committee of the selected audit client is part of the inspection process followed by the PCAOB.
14. The audit committee is directly responsible for hiring and compensating the company's independent auditor.
15. Independent auditors can gather information not provided by management through inquiries of the audit committee.
16. Communications from the audit committee to the independent auditor do not include formal approval of audit and permissible nonaudit services.
17. SOX, SEC-related rules, and PCAOB standards are intended to strengthen auditor independence by linking audit partner compensation to audit quality and not to revenues received.
18. The evidence-gathering phase requires an auditor to review work papers to ensure that the audit was conducted in accordance with PCAOB audit standards.
19. The materiality concept has an important role in assessing the reasonableness of accounting estimates.
20. Public companies are exempted from filing the 11-K report with the SEC.
21. When an independent auditor issues an adverse opinion indicating that there is a material weakness in internal control, a stand-alone audit engagement may be desired.

True or False

1. True
2. True
3. False
4. False
5. True
6. False

7. True
8. True
9. True
10. False
11. True
12. False
13. True
14. True
15. True
16. False
17. True
18. True
19. True
20. False
21. True

Multiple Choice Questions

1. Independent auditors are required to document their assessment of reasonable assurance through the use of:

a. The materiality concept.
b. The audit risk model.
c. Both (a) and (b).
d. Neither (a) or (b).

2. External auditors are not and should not be expected to provide absolute assurance regarding reliability of financial statements primarily because of:

a. The nature and limitation of evidence-gathering procedures.
b. Management assertions and financial representations that are not certain by nature.
c. The possibility of false documentation.
d. All of the above.

3. According to academic studies conducted for audit quality, which of the following statement(s) is (are) correct:

a. Big accounting firms are perceived as more likely to disclose a discovered error.
b. There is a negative relationship between auditor tenure and the discovery of material misstatements for the early years.
c. Financial reporting quality is negatively affected by having a large audit firm audit financial statements.
d. All of the above.

4. SOX adds stipulations surrounding employee affiliation between clients and auditors. For example, the audit staff is prohibited from accepting a key financial position with the audit clients for at least:

a. Five years.
b. Three years.
c. Two years.
d. One year.

5. An advantage of the pass/fail audit approach is that:
   a. It does not reflect the quality of the financial statements.
   b. It does not provide relevant or useful information to investors regarding the quality of the company as an investment or credit risk.
   c. It is standard pass/fail language that provides uniformity and improves comparability.
   d. It focuses on fair presentation rather than true and accurate presentation of financial position and results of operations.

6. A company's ability to initiate, measure, authorize, and report financial information in accordance with GAAP is affected by:
   a. Significant deficiencies in internal control.
   b. Inconsequential deficiencies in internal control.
   c. Material weaknesses in internal control.
   d. None of the above.

7. PCAOB AS No. 3 requires auditors to prepare and maintain audit documentation in sufficient detail for at least:
   a. Three years.
   b. Five years.
   c. Four years.
   d. Seven years.

8. Audit firms are permitted to perform which of the following tax services for their audit clients?
   a. Routine tax return preparation and tax compliance.
   b. General tax planning and advice.
   c. Employee personal tax services.
   d. All of the above.

9. Sections 201 and 202 of SOX require that all audit and permissible nonaudit services performed by the company's independent auditor must be approved by the:
   a. Audit committee.
   b. Board of directors.
   c. CEO.
   d. None of the above.

10. Rotation requirements for audit partners other than the lead and concurring partners involved in an engagement are:
   a. Maximum of seven years on and subject to a two-year timeout.
   b. Maximum of two years on and subject to a seven-year timeout.
   c. Maximum of five years on and subject to a one-year timeout.
   d. Maximum of three years on and subject to a two-year timeout.

11. The PCAOB proposed standards and Section 201 on auditor independence prohibit registered auditors from participating in which of the following activities?
   a. Financial information system design and implementation.
   b. Internal auditing outsourcing engagements when acting as external auditor.
   c. Managerial duties.
   d. All of the above.

12. Section 206 of SOX prohibits:

a. Auditors from performing an audit where the CEO or other senior financial executive was employed by the auditor during the preceding year.
b. Auditors from providing any nonaudit services to the company contemporaneously with audit services.
c. Lead audit or concurring partner and reviewing partner from rotating off the audit every five years.
d. Auditors from reporting to the audit committee all critical accounting policies and practices used.

13. Auditor independence provisions along with listing standards of national stock exchanges and auditing best practices are designed to supply which of the following benefits to corporate governance?

a. Reduce potential conflicts of interest between auditors and their client's management.
b. Replace self-regulation and peer reviews.
c. Limit the type of nonaudit services public accounting firms can perform.
d. None of the above.

14. The evidence-gathering activities of an integrated audit engagement consist of:

a. Tests of controls performed on ICFR.
b. Substantive tests performed on account balances and transactions.
c. Both (a) and (b).
d. Neither (a) nor (b).

15. Trend in earnings used by auditors to establish planning materiality is an example of which of the following?

a. Quantitative factor.
b. Qualitative factor.
c. Allocation factor.
d. None of the above.

16. If a detected misstatement is considered to be material then the auditor should:

a. Ask management to correct the misstatement.
b. Use quantitative analysis to solve to problem.
c. Perform tests of controls.
d. Decide on the materiality of the detected misstatements.

17. Controlling the detection risk is the primary responsibility of the:

a. Management.
b. Auditor.
c. CEO.
d. Controller.

18. Company-level controls identified by COSO are related to the company's:

a. Control environment.
b. Board of directors' effectiveness.
c. Management competency.
d. All of the above.

19. Which of the following is (are) guidelines provided by the PCAOB?

a. Communication with audit clients regarding internal control issues should be minimized.

b. Use of a bottom-up approach of focusing on company-level controls should be implemented.
c. Audits of internal control and financial statements should be integrated.
d. All of the above.

20. Establishing and overseeing an independent Audit Inspection Unit is the responsibility of which of the following boards?

a. Professional Oversight Board (POB), formerly Professional Oversight Board for Accountancy (POBA).
b. Auditing Practices Board (APB).
c. Accountancy Investigation and Discipline Board (AIDB).
d. Both APB and AIDB.

21. Independent auditors are subject to which of the following liabilities?

a. Civil liability.
b. Criminal liability.
c. Both civil and criminal liabilities.
d. Neither civil nor criminal liability.

22. The adopted Interim Professional Standards are existing standards promulgated by the AICPA and are classified by the PCAOB into five categories out of which rule 3300T stands for:

a. Interim Attestation Standards.
b. Interim Quality Control Standards.
c. Interim Ethics Standards.
d. Interim Auditing Standards.

Multiple Choice Questions

1. c.
2. d.
3. a.
4. d.
5. c.
6. a.
7. d.
8. d.
9. a.
10. a.
11. d.
12. a.
13. a.
14. c.
15. b.
16. a.
17. b.
18. d.
19. c.
20. a.
21. c.

22. a.

Chapter 10

Review Questions

1. What are the interrelation factors on which the effectiveness of the monitoring and control function by investors is based?

- Property rights established by law or contractual agreement that define the relations between a company's investors and its management, as well as the existence of such relations between different types of investors.
- Financial systems facilitating the supply of finances between households, financial intermediaries, and corporations.
- Networks of intercorporate competition and cooperation establishing relations between corporations in the marketplace.

2. Explain the two alternative modes of financial mediation between households (investors) and corporations.

- The first mode is bank-based finance where banks take deposits from households and channel this savings into loans made to companies.
- The second mode is market-based finance in which households, directly or indirectly through retirement plans, invest in equity or debt securities issued by corporations.

3. Discuss the five rules that the BRT recommends for fair and respectful treatment of shareowners and their views.

- Public companies should have procedures for shareholders to communicate with the board and for directors to respond to shareholders' concerns.
- All communications with shareholders should be consistent, fair, transparent, clear, and candid.
- The established shareholder communication procedures should be readily available to shareholders.
- The company's board should be notified of all shareholder proposals and the board or its corporate governance committee should oversee the company's response to shareholder proposals.
- Directors should attend the annual meeting of shareowners and should respond or ensure that management responds to all relevant questions.

4. What are the policies and procedures that should be established by the nominating committee to better enhance the viability of shareholders' nominations?

- Receive shareholders' nominations for board candidates and proposals for significant strategic decisions.
- Consider nominees and proposals received from small individual investors.
- Communicate with shareowners.

5. What situations can lead to institutional investor intervention with the invested company?

Intervention may occur in situations where there are concerns about strategy, operational performance, mergers and acquisitions strategy, inadequate oversight function by independent directors, reported material weaknesses in internal controls, inadequate succession planning, noncompliance with corporate governance reforms, inappropriate executive compensation plans, lack of commitment to social, environmental, and ethical issues, material financial restatements, and corporate malfeasance and fraud.

6. How can institutional investors participate in the corporate governance of the company?

- Exercise their right to elect directors.
- Raise their concerns about the company's governance by either selling their shares or voicing their dissatisfaction.
- Improve the efficiency of the capital markets by transmitting private information they obtain from management to the financial markets.
- Reduce agency problems by possessing resources and expertise to monitor the managerial and oversight functions as well as reduce information asymmetry between management and investors.

7. Explain the advantages of employee participation in corporate governance.

- Through ownership of company shares employees have more incentives to align their interests with those of shareholders.
- Employee involvement in corporate governance is a learning process for employees to advance their position and improve the company's operational efficiency.
- Employee participation in corporate governance can be regarded as an internal mechanism to monitor managerial performance and prevent management opportunistic conduct.

Discussion Questions

1. What factors and opportunities have led to the movement of direct individual ownership of stocks to a more institutional ownership structure?

Factors contributing to this change are the move toward institutionalization of financial markets through financial institutions, privatization of pension plans, and individual investors' preference toward long-term investments.

2. The author states that investors should also share some of the blame for reported financial scandals for their lack of monitoring of their companies' governance. Do you agree or disagree with this statement? Why?

Answers may vary. The publicized financial scandals of the early 2000s originated from the use of aggressive accounting and earnings management practices of the late 1990s. Financial irregularities and earnings management practices of many companies definitely sent strong signals of forthcoming financial scandals. Nonetheless, investors either did not want to ask tough questions about their governance or did not care as long as the stock prices were going up. Earnings management practices of prominent companies were reported in the press but investors did not raise many concerns about the irregularities of these companies that were making profit for them. The economic downturn, stock market plunges of 2000 and 2001, failures of Enron, WorldCom, Adelphia, Global Crossing, and others, and ineffectiveness of their corporate governance made investors angry where the roots of these problems trace back to the capital market inefficiency of the 1990s. The two biggest corporate bankruptcies in U.S.

history, Enron and WorldCom, and the failures of other high-profile companies primarily caused by fraud, which cost investors and pensioners over $500 billion, made investors take notice and demand corporate accountability.

3. Traditionally, the accountability and transparency between the board and shareholders have not been effective in the sense that the board was not informed of what shareholders were expecting of it and shareholders were not aware of the board's activities and its effectiveness. What should be done about this communication gap? Substantiate your answer.

Answers may vary. Shareholders have voting rights to elect directors as their agents; however, individual directors have no direct responsibility or accountability to shareholders. Traditionally, public companies have used a plurality-vote system to elect corporate directors. Under a plurality-vote system, directors can be elected by the vote of a single share unless they are opposed by a dissident director. Conversely, a majority-vote system empowers shareholders to elect the most qualified outside directors. The nominating committee can play an important role in promoting majority voting and developing an efficient mechanism for shareholders to nominate or endorse director candidates. This may give shareholders more responsibility in selecting directors to the board, which may in turn alleviate the communication gap between the board of directors and shareholders.

4. Investors may think they live in the United States of America but when it comes to electing corporate directors, shareholders' intended watchdogs in the boardrooms, they are definitely back in the U.S.S.R. Compare or contrast this statement with your own views.

The ability of shareholders to vote against or fire underperforming directors is limited under the commonly used plurality-vote system. Shareholders do not have access to their company's proxy materials and are not empowered to nominate their candidates for the board. The increase in corporate governance awareness may result in improved shareholder democracy, giving investors a stronger voice in relation to corporate operations.

5. Do you feel the extent of shareholders' participation in the election of directors is limited to the rubber-stamp process of affirmation? Explain the given statement.

Shareowners are empowered under state corporate statutes to elect directors to oversee management, but in reality, they have no real voice in the nomination and election process. The real election appears to be cast in the boardroom due to the fact that even if the majority of shareholders oppose a corporate-sponsored nominee, that person will still be elected as a director. Until very recently, CEOs/chairs of the board had significantly influenced the nomination and election of new directors. The requirement for the establishment of a nominating committee composed solely of independent directors has provided some structure to the nomination and election process even though in many cases independent directors still serve at the will of the CEOs and other executive directors.

6. Elaborate on the following statement: "In modern corporations, particularly in the era of technological advances, labor resources are becoming an important part of corporate governance as capital resources."

The balance of power and association between property rights, managerial control, and employee participation rights can play an important role in the effectiveness of corporate governance. Employee participation in corporate governance can influence managerial control and authority, and can influence employee cooperation in the implementation of decisions. The shape and extent of employees' participation in corporate governance is a function of the employee level of investment in the company's stock through retirement plans and whether their skills are firm-specific. In a situation in which employees invest in skills specific to their company and their retirement funds and pensions are tied to the company's stock, their incentives to participate in corporate governance are greater. Alternatively, when employees' skills are portable across companies and their investments in the company are insignificant, they may prefer strategies of exit over voice in response to dissatisfaction and grievances. Thus, employees' interests in corporate governance are shaped by their economic, investment, and employment ties to the company, as well as their participation in managerial decisions.

7. The Council of Institutional Investors (CII) recommends six shareholder voting rights. Search the Internet for examples of organizations that implement those recommendations.

The following are the shareholder voting rights recommended by the Council of Institutional Investors (CII): (1) access to the proxy; (2) one share, one vote; (3) confidential voting; (4) voting requirements; (5) broker votes; and (6) bundled voting. The student can search the business press, an applicable database, or a search engine to find information related to these recommendations as well as examples of organizations implementing such recommendations.

8. Discuss shareholders' participation in monitoring their companies' affairs, decisions, and corporate governance.

Investors, particularly institutional investors, should be engaged actively in monitoring their companies' corporate governance and fundamental decisions. Investors should participate in important affairs and engage with companies where value can be added to their investments. By virtue of their influence and power, institutional investors should intervene when ineffectiveness or breakdowns in corporate governance occur to assist in protecting sustainable shareholder value. Individual shareholders can change managerial directions and decisions by selling their shares when there is corporate underperformance, and if the majority of shareholders follow suit, management will be forced to act. In the case of institutional investors where funds are indexed with limited ability to sell, institutional engagement in corporate governance is the only way to correct ineffectiveness in corporate governance.

9. Describe how shareholder proposals can influence corporate governance.

The company's board normally communicates with shareholders in obtaining their approvals on resolutions. Shareholders are also given the opportunity to address issues of their interests through specific shareholder proposals. Traditionally, shareholder proposals have been nonbinding and therefore the board could choose to ignore them even if they received a majority of favorable votes. In reality, for these proposals to influence corporate governance, they should be binding. Recently, proxy voting advisors, such as Glass Lewis & Co. and Institutional Shareholder Services (ISS), have played an important role in influencing board agendas and the proxy process.

True or False

1. American households are more likely to have direct ownership of public company stock now than in 1950.
2. Shareowners with significant ownership positions theoretically have more incentives and opportunities to engage in the monitoring function.
3. The publicized financial scandals of the early 2000s originated from the use of conservative accounting and earnings management practices of the late 1990s.
4. Property rights establish the legal relations between a company's investors and its management as well as the relations among different types of investors.
5. Bank-based finance is a mode of financial mediation where banks take deposits from households and channel this savings into loans made to companies.
6. The use of plurality voting rather than majority voting substantially increases the ability and influence of shareholders over who is actually elected to the board.
7. Involvement of institutional investors in the monitoring function of corporate governance limits agency problems associated with the separation of ownership and control in public companies.
8. The chief compliance officer is accountable to the mutual fund's board and can be terminated by the board or a shareholder coalition.
9. Due to the rash of financial scandals of high-profile companies, investors have become more active in monitoring the corporate governance of companies.
10. Employee participation in corporate governance can be regarded as an external mechanism to monitor managerial performance and prevent management opportunistic conduct.
11. Mutual funds must either establish a code of ethics or disclose in their annual report why they have not adopted such a code.

True or False

1. False
2. True
3. False
4. True
5. True
6. False
7. True
8. False
9. True
10. False
11. False

Multiple Choice Questions

1. **Which of the following groups typically own the most public corporation shares?**
    a. Directors, officers, employees.
    b. Individual outside shareholders.
    c. Financial institutions.
    d. All of the above typically own a similar amount.
2. **_______ establish(es) the legal relations between the investors of a corporation and its management.**
    a. The articles of incorporation.
    b. Property rights.
    c. The corporate charter.
    d. Proxy statements.
3. **_______ provide a means of financing and corporate ownership that fundamentally constitutes the supply side of capital markets.**
    a. Property rights.
    b. Intercorporate networks.
    c. Financial systems.
    d. None of the above.
4. **The relation between the company and other corporations or organizations is determined by:**
    a. Intercorporate networks.
    b. The structure of power and opportunity.
    c. Corporate governance.
    d. None of the above.
5. **Providing timely access to information, enhancing shareholders' rights, and promoting shareholder democracy can result in:**
    a. Positive effects on corporate governance.
    b. Negative consequences such as directors challenging the CEO's preferences.
    c. An increase in the likelihood that a merger or acquisition will ensue.
    d. All of the above.
6. **Which of the following would be considered a method of institutional investor intervention?**
    a. Meeting with directors, particularly independent directors, lead directors, or the chairperson of the board.
    b. Making a public statement in advance of annual shareholder meetings.
    c. Submitting resolutions and proposals for vote at shareholders' meetings.
    d. All of the above.
7. **The first level of agency problems is associated with:**
    a. Potential conflicts of interest between individual investors and their trustees and fiduciaries.
    b. Potential conflicts of interest between professional money managers and corporations and their corporate clients.
    c. Ownership society.
    d. Monitoring public companies' governance, affairs, and business.
8. **Which one of the following is among the plans considered by the SEC:**
    a. Standardize exchange governance by requiring U.S. stock exchanges to file quarterly reports with regulators.

   b. Ensure that a majority of directors are not independent.
   c. Ensure that members of the nominating, governance, audit, compensation, and regulatory committees are not entirely independent.
   d. Limit exchange members' ownership interest to 35 percent.

9. The core principles do not provide considerations for:
   a. Board independence & leadership.
   b. Board processes & evaluation.
   c. Individual director characteristics.
   d. Shareowner rights.

10. Employee performance of an assigned job should be compensated through:
   a. Salary-based pay.
   b. Stock ownership to encourage employees to devote and retain these skills in the company.
   c. Stock options.
   d. Fringe benefits.

11. Shareholder rights are enhanced by providing means for:
   a. Asking questions and raising concerns.
   b. Tabling resolutions.
   c. Voting in absentia.
   d. All of the above.

12. Only large shareowners and particularly institutional shareholders have incentives and resources to monitor companies' governance and other shareholder benefits because:
   a. Corporate ownership in the United States is highly dispersed and diffused.
   b. The incentives and opportunities for individual investors to monitor the company's governance are very remote.
   c. Individual investors cannot afford the high costs of monitoring.
   d. All of the above.

Multiple Choice Questions

1. c.
2. b.
3. c.
4. a.
5. a.
6. d.
7. a.
8. a.
9. d.
10. a.
11. d.
12. All of the above.

Chapter 11

Review Questions

1. **How does a legal counsel play an important role in corporate governance?**
   Legal counsel plays an important role in presenting and analyzing relevant information as well as providing valuable advice to the company's board of directors, committees, officers, and employees in effectively discharging their assigned responsibilities. Legal counsel plays an important role in corporate governance by providing professional advice to the company's directors, officers, and other key employees, and ensuring that the company is in compliance with all applicable laws, regulations, and rules.
2. **What is the purpose of the legal counsel serving as advisors to management?**
   The purpose is to identify financial reporting risks for management and any noncompliance with regulations in financial disclosures to investors.
3. **Why is reliable and transparent information a necessity to operate an efficient market?**
   Investors need reliable and transparent information to make rational investment decisions and to allocate their capital properly.
4. **What is "Regulation AC"?**
   The SEC final rule *Regulation Analyst Certification* (Regulation AC) addresses concerns regarding the independence of research from investment banking and the analysts' perceived conflicts of interest. Regulation AC requires brokers, dealers, and certain other associated persons to incorporate into their research reports certification by the research analyst.
5. **What are the standards of best practices governing the relationship between corporations and their analysts?**
   - Information flow.
   - Analyst conduct.
   - Corporate communications and access.
   - Reviewing analyst reports or models.
   - Issuer-paid research reports.

Discussion Questions

1. **List external participants in corporate governance who help monitor the corporate governance structure and provide advice to internal participants.**
   Professional, legal counsel, financial advisors, investors, securities analysts, institutional investors, investment bankers, pension funds, credit-rating agencies, and the media.
2. **Should attorney-client privileges be waived in certain situations? Explain.**
   Answers may vary. The issue of attorney-client privilege has been controversial and unresolved in the post-SOX period. Corporate attorneys have been pressured to waive the privilege in connection with government (SEC) investigations. In December 2006, the Department of Justice revised its guidelines for prosecuting corporate fraud. The new guidelines promote the preservation of corporate legal privileges and establish new requirements for prosecutors who seek privileged information from companies. Prosecutors must obtain approval from the U.S.

Attorney and prove a legitimate need before requesting waivers of corporate privileged information unless the company voluntarily waives such privileges. Prosecutors also refrain from considering in their charging decision whether a company advances legal fees to former or current employees who are subjects of an investigation. Thus, prosecutors are restricted but not prohibited from seeking corporate privilege waivers. This includes request waivers of attorney-client or work product protections when there is a legitimate need for the privileged information. The new guidelines, however, provide greater protection for the attorney-client privileged communication.

3. With respect to attorneys, will the imposition of SEC rules relating to ethics positively impact behavior?

Answers may vary. It is expected that SEC rules will lead to more ethical lawyers who contribute to the achievement of business ethics. Lawyers played a role in financial scandals by either facilitating management impropriety or not detecting and preventing management misconduct. The general understanding is that when management and accountants are attempting to break the law, it is the professional responsibility of legal counsel to detect and prevent the wrongdoing rather than act as facilitators or enablers of wrongdoing.

4. What has contributed to the improvement of information since the SEC implemented "Regulation Analyst Certification" (Regulation AC)?

Answers may vary. Several factors may have contributed to the improvement of the information environment after the implementation of Regulation AC. First, Regulation AC may have improved the credibility and integrity of analyst research reports by reducing potential conflicts of interest. Second, investor confidence in analyst research reports may have improved because of mere certifications of those reports. Finally, companies may have increased the quality and quantity of information provided to analysts or disseminated through public disclosures.

True or False

1. The Task Force of the ABA recommends regular and periodic executive session meetings between their general counsel and the committee of independent directors.
2. Section 501 of SOX directs the SEC to establish rules of professional conduct for lawyers appearing and practicing before the commission.
3. The SEC has issued numerous rules that govern the standards of professional conduct for attorneys appearing and practicing before the SEC on behalf of public issuers.
4. The company's chief legal officer (CLO) is responsible for determining if alleged material violations have occurred or are likely to occur.
5. A qualified legal compliance committee, under the SEC rule, is a committee that is composed of at least two members of the company's audit committee and two or more independent directors.
6. SEC rules require investment advisors to establish policies and procedures to guide their proxy voting in the best interest of their clients.
7. Securities analysts are hired by brokerage firms to analyze financial performance of the corporations they follow, assess the quality of the company as an investment, and make recommendations for investment opportunities based on their analysis.

8. Section 307 of SOX directs the SEC to issue rules addressing securities analyst conflict-of-interest issues.
9. Both NASD Rule 2711 and the amended NYSE Rule 472 are designed to manage, monitor, and disclose research analysts' conflicts of interest in connection with research reports on equity securities and public appearance.
10. An increase in the objectivity and credibility of analyst reports and forecasts will lead to a higher consensus among analysts and lower forecast dispersion.
11. Public companies usually retain numerous outside lawyers.
12. Academic research documents investors react more strongly to forecast revisions of analysts with high prior forecasting accuracy.

True or False

1. True
2. False
3. True
4. True
5. False
6. True
7. True
8. False
9. False
10. True
11. True
12. True

Multiple Choice Questions

1. The corporate legal structure consisting of both the internal lawyers and external legal team should work together and synchronize their objectives and responsibilities as:
   a. Counselors to the board, its committees, and its directors.
   b. Advisors to management.
   c. Gatekeepers to ensure compliance.
   d. All of the above.

2. What are the approval responsibilities that the board of directors has to the legal counsel?
   a. Appointment, retention, and compensation.
   b. Appointment and retention.
   c. Retention and compensation.
   d. Compensation and appointment.

3. To effectively promote a culture of compliance within the company:
   a. Lawyers should bring legal compliance issues to the attention of appropriate authorities.
   b. Lawyers should play an important role in presenting and analyzing relevant information.
   c. Retained outside lawyers should not communicate with employed inside lawyers.

d. None of the above.

4. Casual communication of key legal issues from the legal counsel to the board of directors may create which of the following relationships?

a. An independent relationship between the company's directors and its officers.
b. An increasing relationship between the company's directors and its officers.
c. An adverse relationship between the company's directors and its officers.
d. A positive relationship between the company's directors and its officers.

5. The Task Force of the American Bar Association makes which of the following suggestion(s) to a company's general counsel?

a. The company's general counsel should establish policies and procedures for outside lawyers to communicate with the general counsel regarding material violations.
b. The company's general counsel should have no communication with outside lawyers to maintain independence and confidentiality.
c. The company's general counsel should establish rules of professional conduct for lawyers.
d. The company's general counsel should report corporate misconduct to the company's shareholders or CEO.

6. The SEC requires that the qualified legal compliance committee be composed of what minimum member structure?

a. One member of the audit committee and two independent directors.
b. Two members of the audit committee and one independent director.
c. Two members of the audit committee and two independent directors.
d. One member of the audit committee and one independent director.

7. Section 501 of SOX directs the SEC to issue rules that pertain to what corporate governance subject?

a. Securities analyst conflicts of interest issues.
b. Internal control reporting.
c. Auditor rotation.
d. None of the above.

8. Which of the following is the intended purpose of Regulation AC?

a. To decrease the objectivity and credibility of analyst reports and forecasts.
b. To decrease consensus among analysts.
c. To improve the objectivity and credibility of analyst reports and forecasts.
d. To decrease the quality and quantity of information provided to analysts.

9. Among the standards of best practices, information flow means that analysts should:

a. Conduct their research and recommendations with utmost objectivity, independence, fairness, and unbiased opinion.
b. Not discriminate among recipients of the information disclosed based on the recipient's prior research, recommendations, earnings estimates, conclusions, and opinions.
c. Not disrupt or threaten to disrupt the free flow of information between corporations, investors, and analysts.
d. Only accept cash compensation for their research work.

Multiple Choice Questions

1. d.
2. a.
3. a.
4. c.
5. a.
6. a.
7. a.
8. c.
9. c.

Chapter 12

Review Questions

1. How does IT serve as a benefit and tool for the overall objectives of corporate governance?

IT can play an important role in corporate governance as a tool to improve the efficiency and effectiveness of corporate governance. IT is an essential component of corporate governance as an effective means of delivering timely and accurate information for planning, monitoring, and reporting purposes. The effectiveness of all corporate governance functions depends on the quality of support received from the IT function. The IT function enables other corporate governance functions to operate in real-time, online processes facilitating simultaneous decision making, continuous monitoring, instantaneous assessment electronic reporting, and continuous auditing.

2. How do public companies benefit from electronic communication? How do shareholders benefit from electronic communication?

Companies can:

- Save the substantial costs of paper-based production and dissemination of annual proxy and financial statements.
- Improve the timeliness and transparency of communications with shareholders.

Shareholders can:

- Use electronic means in communicating with their companies.
- Participate in meetings that might otherwise be inaccessible or difficult to attend because of the constraints of time or location.

3. What is e-commerce? What are the different e-commerce strategies?

E-commerce is defined as conducting business affairs, transactions, and communications over the Internet or through private online networks.

E-commerce strategies are classified into: (1) business to business (B2B); (2) business to consumer (B2C); (3) consumer to consumer (C2C); (4) business to government (B2G); (5) government to government (G2G); and (6) government to consumers (G2C).

4. What is information infrastructure? Explain how it is influenced by the board of directors and top management.

Information infrastructure determines the way financial information is generated, processed, analyzed, audited, and used in making business and investment decisions. It is influenced by directors in overseeing the financial reporting process, internal controls, and audit activities, and by the top management team in designing sound accounting and internal control systems and in certifying its financial statements and ICFR.

5. What is SOX-Pro?

SOX-Pro is a dual-purpose solution with some elements designed to track documents and provide access control, auto-alerts, continuous monitoring, and management reports to comply with Sections 302 and 404, and other elements designed to provide internal network security management.

6. Discuss the meaning and purpose of the "Internal Fraud Vulnerability Assessment Tool" (IFVAT).

IFVAT is used by auditors to assess internal control weaknesses as part of compliance requirements with provisions of SOX, particularly Section 404. It uses a standard risk assessment methodology to determine the likelihood of fraud and its possible impacts by asking more than 300 questions and measuring risk for the most common internal fraud schemes including skimming, inventory and equipment theft, corruption, and financial statement fraud.

7. Explain the function of the eXtensible Business Reporting Language (XBRL).

It enables business reporting information to be transferred automatically between different computer platforms and applications and allows the selection, analysis, storage, and exchange of tagged data that can be displayed automatically in various formats.

8. What are the intended purposes of XBRL?

- To enhance users' ability to search the filings database.
- To extract and analyze financial information.
- To perform financial comparisons within industries.
- To facilitate the SEC's review of filings.

9. What are the purposes of the XBRL-GL technology?

XBRL-GL enables the development of a standardized vocabulary for:

- Efficient communication between accountants.
- Expressing information from business documents that flow into financial reports.
- Moving information between accounting systems, spreadsheets, and service providers.

10. What are the advantages of XBRL-GL?

- Reporting independence.
- System independence.
- Consolidation.
- Flexibility.

11. What is continuous auditing? Explain the benefits of continuous auditing.

Continuous auditing is a comprehensive electronic audit process that enables auditors to provide some degree of assurance on continuous information simultaneously with, or shortly after, the disclosure of the information. The benefits are:

- Reducing the cost of an audit engagement by enabling auditors to test a larger sample of a client's transactions.
- Reducing the amount of audit resources needed to manually perform tests of controls and substantive tests.
- Increasing the quality of financial statement audits by allowing auditors to use the integrated audit approach of understanding the client corporate-level controls.
- Specifying transaction selection criteria to choose transactions or transaction cycles and perform integrated audits.

12. What is an XBRL instance document?

An XBRL instance document is a stand-alone document of a machine-readable format of financial information consisting of numerous data points and their corresponding XBRL tags that may be published using email, a Web site, or other electronic distribution means.

<u>Discussion Questions</u>

1. Discuss the impact that the Internet, globalization, and regulations are having on corporate governance reforms.

The Internet has allowed many different people, groups, and organizations to exchange information regarding corporations and their business practices. This makes users of information more informed to make better decisions. The emergence of the Internet has also had an impact on corporate financial information dissemination via Web sites. Globalization has aided in the convergence of corporate governance and financial reporting standards worldwide, ushering in related governance reforms. Regulations impact the structure of governance within countries and their organizations, leading to corporate governance reforms related to those changes.

2. How have modern video conferencing and other methods of telecommunications impacted the corporate governance of public companies?

Modern video conferencing, or "Web cam" technology, enables companies to conduct their meetings electronically without requiring everyone to be physically present. This allows individuals, both inside and outside of organizations, to more effectively communicate with each other regarding many issues (including corporate governance matters).

3. Research current business literature or the Internet for examples of the six e-commerce strategies.

Answers may vary. E-commerce strategies are classified into: (1) business to business (B2B), the online exchanges of products, services, and business transactions between businesses and suppliers; (2) business to consumer (B2C), conducting business online with consumers; (3) consumer to consumer (C2C), where consumers trade among themselves; (4) business to government (B2G), exchanging transactions between business and governmental entities; (5) government to government (G2G), consisting of online programs and activities between governmental agencies; and (6) government to consumers

(G2C), where online transactions are exchanged between governmental entities and consumers. Examples may be found using a search engine or database.

4. "The business framework has transformed from 'brick-and-mortar' to a 'brick-and-click' infrastructure." Compare this statement with your views and cite some examples.

Answers may vary. Almost all traditional retailers have established online trades. Electronic commerce (e-commerce) has become an integral component of business strategies and has altered the way organizations conduct their daily operations.

5. What are the four factors that can differentiate the corporate governance structure from one country to another?

Legal infrastructure, regulatory environment, information infrastructure, and market infrastructure.

6. What factors help shape the corporate governance structure of multinational corporations?

The host and home countries' legal, political, cultural, and regulatory systems, the business practices and historical patterns of countries, global capital, labor, and managerial markets, global institutional investors, and boards of directors.

True or False

1. While complying with Sections 404 and 802 of SOX, the use of IT solutions for timely access to secure and complete business documents is necessary.
2. Existing corporate laws permit the use of electronic communications as a means of shareholder communication.
3. Government to government (G2G) strategy involves online transactions that are between governmental entities and consumers.
4. The information infrastructure of corporate governance is not affected by the company's legal counsel.
5. Section 409 requires public companies to rapidly report events that could affect their performance.
6. Using the standard XBRL format, investors have access to the same information as analysts.
7. XML-tagged data cannot be sent across the Internet in a universal, platform-independent language.
8. Any suspicious or fraudulent activities can be monitored by analytics software.
9. FRAANK enables organizations to integrate accounting numbers with other financial information publicly available on the Internet, including stock quotes and analyst earnings forecasts.
10. Data integration consists of the capability to provide for the seamless exchange and aggregation of financial data.

True or False

1. True
2. False
3. False

4. False
5. True
6. True
7. False
8. True
9. True
10. True

Multiple Choice Questions

1. What challenges are intruding upon the corporate governance structures of the twenty-first century?

a. Internet.
b. Globalization.
c. Regulations.
d. All of the above.

2. By using electronic communication, companies can do which of the following?

a. Increase costs.
b. Improve the timeliness and transparency of communications.
c. Participate in virtual meetings.
d. None of the above.

3. The business-to-business (B2B) strategy is best defined by which of the following?

a. Conducting businesses online with consumers.
b. Online transactions exchanged between governmental entities and consumers.
c. Online exchanges of products, services, and business transactions between businesses and suppliers.
d. Online programs and activities between governmental agencies.

4. The quality of public financial information is increased by which of the following:

a. Competence and integrity of providers of information.
b. Soundness of accounting principles.
c. Effectiveness of the related internal controls.
d. All of the above.

5. Sections 302 and 404 of SOX require public companies to:

a. Disclose controls, procedures, management assessment, and reporting on internal control over financial reporting.
b. Report in a timely manner events that could affect their performance.
c. Offer complete, secure, and timely access to documents.
d. None of the above.

6. Which of the following is/are benefits of using XBRL-tagged data system?

a. XBRL data changes from the time and place of origination to their eventual designation and use.
b. XBRL can be used on any computer hardware equipment or operating system to store data.
c. Both (a) and (b).
d. Neither (a) nor (b).

7. **Widespread application of the XBRL format will only be successful upon:**
   a. the acceptance and requirement of XBRL-tagged data for financial reporting.
   b. the acceptance and requirement of XBRL-tagged data for tax purposes .
   c. the development of appropriate XBRL taxonomies for all industry segments.
   d. All of the above.
8. **XBRL taxonomy is best described as:**
   a. Taxes levied against certain advanced technological uses.
   b. Mechanisms for describing, naming, and classifying items of business information.
   c. Advanced procedures for identifying uses of computer hardware.
   d. None of the above.
9. **Which of the following is an advantage of XBRL-GL?**
   a. Reporting independence.
   b. System independence.
   c. Consolidation.
   d. All of the above.
10. **Which of the following is a benefit provided by continuous auditing?**
   a. Reduction of the cost of an audit engagement by enabling auditors to test a larger sample of a client's transactions.
   b. Increase in the amount of audit resources needed to manually perform tests of controls and substantive tests.
   c. Decrease in the quality of financial statement audits by allowing auditors to use the integrated audit approach of understanding the client corporate-level controls.
   d. All of the above.
11. **Corporate law, tort law, and bankruptcy law are all items that help sustain the:**
   a. Legal infrastructure.
   b. Regulatory environment.
   c. Information infrastructure.
   d. Market infrastructure.
12. **Which of the following standards boards have interrelated definitions of the financial statement elements: assets, liabilities, equity, revenue, and expenses?**
   a) FASB.
   b) IASB.
   c) Both IASB and FASB.
   d) Neither ISAB nor FASB.
13. **Authentication technologies include:**
   a. The hardware and software procedures and processes to protect a person's privacy and identity from internal and external threats.
   b. DVD, electronic document storage, and network attached storage (NAS).
   c. Transfer of voice or data from one device to another through the airwaves without physical connectivity.
   d. All of the above.

Multiple Choice Questions

1. d.
2. b.

3. c.
4. d.
5. a.
6. b.
7. d.
8. b.
9. d.
10. a.
11. a.
12. c.
13. a.

Chapter 13

Review Questions

1. What are the different types of NPOs?

- State and local governments.
- Healthcare organizations.
- Colleges and universities.
- Charitable organizations.

2. What is the primary purpose of NPOs?

To serve the public, achieve philanthropic purposes rather than maximizing shareholder wealth like for-profit companies.

3. Discuss the role of the Panel on the Nonprofit Sector.

To demonstrate the role of charitable organizations in American life and to strengthen the accountability, transparency, and governance of NPOs.

4. What are the principles developed by the Panel on the Nonprofit Sector and why were they established?

The panel developed eight principles regarding the role of charitable organizations, the responsibilities of the charitable community, and the need for balanced government oversight. The suggested principles are:

- A vibrant charitable community is vital for a strong America.
- The charitable sector's effectiveness depends on its independence.
- The charitable sector's success depends on its integrity and credibility.
- Comprehensive and accurate information about the charitable sector must be available to the public.
- A viable system of self-regulation and education is needed for the charitable sector.
- Government should ensure effective enforcement of the law for charitable organizations.
- Government regulation should deter abuse in the charitable sector without discouraging legitimate charitable activities.
- Compliance with applicable laws and high standards of ethical conduct should be required and commensurate with the size, scale, and resources of the organization.

5. **Explain how whistleblower programs help public companies.**
   Whistleblower programs facilitate employees voicing their concerns and reporting corporate wrongdoing to authorities without the risk of retaliation or losing their job.
6. **Explain the role of the governing board in an NPO.**
   The governing board is directly responsible and ultimately accountable for the organization's affairs and, in large NPOs, provides more of an oversight function rather than the managerial function of directly making decisions. In small NPOs, the governing board may perform both managerial and oversight functions.
7. **Explain the role of internal governance in NPO.**
   Assess performance, reward good performance, and discipline poor performance.
8. **How can NPO directors or trustees avoid conflicts of interest?**
   NPO directors or trustees avoid conflicts of interest by: (1) not engaging in material transactions with the NPO; and (2) not serving as an attorney, or providing other services for substantial fees.
9. **Explain the three major fiduciary duties of the board of directors.**
   - Duty of obedience, which requires directors and trustees to carry out their assigned responsibilities.
   - Duty of care, which requires directors and trustees to exercise due care, diligence, and skill.
   - Duty of loyalty, which requires directors and trustees to carry out their activities in pursuing the best interests of the organization by avoiding self-dealing and self-serving activities.
10. **What are the qualities of an effective board member?**
    - Vision.
    - Leadership.
    - Stewardship.
    - Skill.
    - Diligence.
    - Collegiality.
11. **What are the governance documents of NPOs?**
    - Mission statement.
    - Code of conduct.
    - Charter.
    - Bylaws.

Discussion Questions

1. The Panel on the Nonprofit Sector has made a long list of recommendations calling for improvement within the nonprofit sector, more effective oversight, and changes in the law. Review the recommendations and discuss the recommendations that you agree or disagree with.

Answers may vary based on which recommendations are agreed or disagreed with.

- Effective oversight of the charitable sector requires vigorous enforcement of federal and state law.

- Annual information returns filed to the IRS (Forms 990, 990-EZ, and 990-PF) should be improved.
- Congress should implement a new periodic review system to verify that charitable organizations continue to meet the qualifications for tax exemption.
- Congress should require charitable organizations with annual revenues of between $250,000 and $1 million to have an annual financial statement audit and those with more than $1 million to have their financial statements be reviewed quarterly and audited annually by independent auditors.
- Charitable organizations should provide more-detailed information about their operations and performance to the public through annual reports, a Web site, or other means.
- Regulations governing donor-advised funds should be strengthened to ensure that donors and related parties do not receive inappropriate benefits from those funds.
- Every supporting organization should be required to reveal on its Form 990 whether it is operating as a Type I, II, or III supporting organization with particular limitations for activities of Type II organizations.
- Tax-exempt organizations are subject to the same requirements as taxable entities with regard to reporting their participation in potentially abusive "listed" or other "reportable" tax shelter transactions with applicable penalties for engaging in aggressive tax shelters.
- Congress should strengthen the rules for the appraisals taxpayers can use to substantiate deductions claimed or property donated to charitable organizations and for the violation of these rules.
- Charitable organizations should be discouraged from providing compensation to their board members, and when such compensation is provided the amount, reason, and method of determination should be fully disclosed.
- Charitable organizations should be required to disclose clearly the compensation paid to their CEO, other "disqualified persons" determined by the IRS, and the five highest-compensated employees.
- Charitable organizations should establish and enforce appropriate travel expense policies to pay for or reimburse travel expenses of board members, officers, employees, consultants, volunteers, or others traveling to conduct the business of the organization.
- Charitable organizations should have a minimum of three members on its governing board to be qualified as a 501(c)(3) tax-exempt organization, and at least one-third of the governing board members should be independent to qualify as a public charity rather than a private foundation.
- Charitable organizations should include individuals with some financial literacy on their boards of directors and those whose financial statements are audited should consider establishing a separate audit committee of the board.
- Charitable organizations should adopt and enforce a conflict of interest policy and the IRS should require them to disclose on their Form 990 series whether they have such a policy.

2. Compare and contrast California's Nonprofit Integrity Act of 2004 to the Sarbanes-Oxley Act of 2002.

California's Nonprofit Integrity Act of 2004 has several similarities with SOX, including reporting requirements and governance of organizational operations developed to deter fraudulent activity. The main difference between California's Nonprofit Integrity Act of 2004 and SOX is the target of the legislation. California's Act applies to charities, commercial fundraisers, fundraising counsels, unincorporated associations, and trusts while SOX applies to public companies.

3. Several provisions of SOX should be applicable to private companies and nonprofit organizations. Which of these do you most agree with? Why?

Provisions that are more applicable to private companies and even NPOs are requirements for: (1) more vigilant and independent directors; (2) audit committees; (3) improvements in the financial reporting process; (4) risk management and internal controls; (5) audit quality; (6) codes of conduct; (7) whistleblower programs; and (8) restriction against document destruction.

4. There are 15 primary responsibilities of the board of directors/trustees of NPOs. Which of those do you feel are the most effective, efficient, and necessary?

Answers may vary on which responsibilities are considered to be the most effective, efficient, and necessary. The primary responsibilities are to:

- Establish the organization's mission and goals.
- Develop strategies to achieve these goals.
- Appoint officers and executives to run the organization.
- Determine the compensation of executives, oversee their work, and evaluate their performance.
- Review the organization's programs and services.
- Oversee financial reporting, internal controls, and audit activities.
- Oversee compliance with applicable laws, rules, and regulations, particularly tax rules.
- Promote ethical behavior and accountability throughout the organization.
- Ensure adequacy and effective use of resources.
- Evaluate the board's performance.
- Approve director/trustee compensation, if any.
- Assess board vacancy and recruit new board members.
- Ensure executives and staff provide the board with relevant and timely information to effectively carry out its fiduciary duties.
- Set an appropriate "tone at the top" promoting ethical conduct throughout the organization.
- Ensure that all board members participate in orientation and continuing education programs.

5. "Not-for-profit organizations are created to serve the public—often individuals other than organizations." Do you agree or disagree with this statement? Support your answer with points regarding transparency, governance, and accountability of charitable organizations.

Governance of NPOs is important in managing and monitoring their activities and balancing their budgets. To serve the public successfully, NPOs should be transparent and accountable for their actions, and have an effective corporate governance structure.

6. Discuss the skepticism among donors and the public at large with respect to the governance and accountability of NPOs, keeping in mind the following two statements:

(1) **"There are concerns that charitable organizations are becoming too business-like and not focusing on passion and commitment to their mission."**

(2) "Public confidence in charities depends on whether they have done a good job helping people and spending money."

NPOs, particularly charities, have been under extensive scrutiny regarding their governance, financial integrity, stewardship of resources, and appropriateness of compensation schemes. Such scrutiny may result in skepticism among donors and the general public regarding the ability of NPOs to adequately control their resources and fulfill their mission. Such skepticism may be suppressed for NPOs with a proven reputation for operating effectively.

7. Explain how the role of CEO in a company is related to role of president in an NPO. Substantiate your answer with examples.

In the business sector, the CEO manages the company; in NPOs, the CEO may be called executive director, president, general manager, superintendent, or director-general. The board grants its authority to the CEO. Executive directors in both public and not-for-profit organizations are charged with making decisions related to the operation of the organization. Examples of both public and not-for-profit executive directors may be found utilizing a search engine or business press.

True or False

1. Not-for-profit organizations are tax-free entities that benefit from zero taxes on all generated revenue.
2. Tax is imposed on tax-exempt organizations for the revenue generated from engagement in a trade or business unrelated to their philanthropic purposes.
3. California's Nonprofit Integrity Act of 2004 requires charities with gross revenues of less than $2 million to establish and maintain an audit committee.
4. Not-for-profit organizations are typically owned by their members, their communities, or their constituencies.
5. Not-for-profit organizations are managed typically by a CEO whose authority is granted by the state NPO council.
6. Risk management assessment and internal controls play an important role in the success of private companies and NPOs.
7. The advisory board of an NPO typically provides advice, gives counsel, and engages in governing the organization.
8. The internal control system of NPOs should ensure that appropriated funds are spent on the designated programs.
9. The directors or trustees of NPOs are typically volunteers or appointed by the sponsoring organization.

10. The development and fundraising committees are responsible for the organization and oversight of fundraising events and capital campaigns.
11. The audit committee is composed of officers and committee chairs that can act on behalf of the entire board between board meetings if circumstances require.
12. One of the most important attributes of audit committees for NPOs is that all members of the committee should be independent.
13. A mission statement is a legal document describing an organization's reasons for existence and its goals.

True or False

1. False
2. True
3. False
4. True
5. True
6. True
7. False
8. True
9. True
10. True
11. False
12. True
13. False

Multiple Choice Questions

1. Not-for-profit organizations receive their operating budgets from which of the following sources?

a. Government grants.
b. Stakeholder contributions.
c. Membership dues and fees.
d. All of the above.

2. According to the recommendations of the Panel on the Nonprofit Sector, to be qualified as a 501(c)(3) tax-exempt organization, an organization should have which of the following governing board structures?

a. A minimum of three members on its governing board.
b. A minimum of two members on its governing board.
c. A maximum of three members on its governing board.
d. None of the above.

3. The Nonprofit Integrity Act of 2004 passed by Californian legislators requires charitable organizations to have audit committees and audited financial reports when gross revenues amount to which of the following values?

a. $2 million or more.
b. $2.5 million or more.
c. $3 million or more.
d. $3.5 million or more.

4. Not-for-profit organizations have begun to adopt many of the SOX provisions required for public companies to improve and sustain their:

a. Corporate governance.
b. Financial reporting.
c. Internal control.
d. All of the above.

5. In a small NPO, the governing board performs the following functions:

a. Oversight function.
b. Managerial function.
c. Both (a) and (b).
d. Neither (a) nor (b).

6. Not-for-profit organizations should have an adequate and effective internal control system to ensure which of the following objectives?

a. The organization is performing efficiently within given budgets.
b. The organization is achieving its program results.
c. The organization's financial reports are reliable and transparent.
d. All of the above.

7. Which of the following committees is usually not prevalent to NPOs?

a. Audit committee.
b. Nominating committee.
c. Personnel committee.
d. Approval committee.

8. The primary responsibilities of the board of directors/trustees of NPOs include:

a. Establishing the organization's mission and goals.
b. Determining compensation of executives.
c. Reviewing the organization's programs and services.
d. All of the above.

9. Teamwork and respect of colleagues most completely define which quality of an effective board member?

a. Collegiality.
b. Stewardship.
c. Leadership.
d. Diligence.

10. Which of the following attributes is specified in the AICPA audit committee charter matrix for government organizations?

a. Audit committee members should be appointed by the board of directors.
b. At least two members of the audit committee should have financial experience.
c. The audit committee should meet at twice a year or more as deemed necessary.
d. Audit committees should have the authority to hire professional consultants as necessary.

11. Rules and procedures for the selection of directors and appointment of officers are developed by the organization's:

a. Charter.
b. Bylaws.
c. Mission statement.
d. Code of conduct.

Multiple Choice Questions

1. d.
2. a.
3. a.
4. d.
5. c.
6. d.
7. d.
8. d.
9. a.
10. d.
11. b.

Chapter 14

Review Questions

1. What are the primary responsibilities of the supervisory board in the German board structure?

The supervisory board is merely a token board with the responsibilities of hiring and firing management board members, shaping the remuneration packages for management board members, and overseeing the work of the management board members but not instructing them on how to do their job.

2. Briefly describe the board structure in Japanese corporations.

Boards of directors in Japanese corporations are primarily composed of insiders who are usually top executives of companies with no outside directors representing small individual investors. Boards of directors do not typically have a monitoring function.

Discussion Questions

1. Discuss the global corporate governance structure.

There is no globally accepted corporate governance structure. Differences in corporate governance structure are primarily driven by a country's statutes, corporate structure, and culture. For example, corporate governance reforms in the U.S. are typically regulator-led whereas reforms in European countries are normally shareholder-led. Nonetheless, the OECD has established a set of corporate governance principles that have received global acceptance.

2. Explain the three commonly used approaches to regulatory reforms in terms of their effectiveness and context.

The three regulatory reforms are: (1) a race to the bottom; (2) a race to optimality; and (3) a race to the top. The race to the bottom concept suggests that global securities regulators, in an effort to attract issuers, deregulate the points that provide issuers with maximum flexibility for their operations at the expense of not providing adequate protections for investors. The race to the top concept suggests that global securities regulators provide maximum protection for investors through rigid regulations and highly scrutinized enforcement at the expense of putting companies in the global competition at a disadvantage with non–cost-justified regulations. The race to optimality concept is a hybrid of the first two concepts, in which both issuers and investors prefer a regulatory regime and jurisdiction that provide cost-justified investor protection.

3. Discuss the primary aspects of corporate governance in the United Kingdom.

The primary aspects of corporate governance in the U.K. pertaining to the board of directors are: (1) a single board collectively responsible for the success of the company; (2) separation of the position of the CEO and the chairman of the board; (3) a proper balance of executive and nonexecutive directors; (4) strong independent audit and remuneration committees; (5) emphasis on objectivity of directors in the interests of the company; (6) transparency of appointments and remuneration; (7) annual evaluation by the board of its performance; and (8) effective rights for shareholders.

4. Describe the new initiatives taken in Japan to improve the infrastructure of its capital markets.

These initiatives are: (1) establishing a cross-sectional framework of a wide range of financial instruments and services (e.g., broadening the definitions of investment schemes including financial instruments); (2) strengthening the quality of independent audits of financial statements; (3) enhancing protections for investors; (4) improving disclosures through quarterly reporting; (5) reporting to management and auditors on internal controls; (6) providing for self-regulatory structures; and (7) increasing penalties against market fraud.

5. Are you expecting many changes in corporate governance reforms in the Middle East and Asia?

Yes. After many decades of European and American domination of global markets, trades and investments are now flowing between the Middle East and Asia. With oil prices riding high, Middle Eastern countries and their investors and companies have funds to invest and Asian countries have the capabilities to attract such investments. It is inevitable that governments in both Asia and the Middle East will create a more hospitable business and investment climate for investments to reach their global potentials.

6. Explain the types of board systems worldwide.

The three commonly used board systems are:

a. A unitary board system where the board of directors and management are the same (e.g. Singapore board system).
b. A two-tier board system where there are two boards, supervisory and management, and the supervisory board has oversight over the management board. The European two-tiered model of corporate governance consists of an executive board and a supervisory board. The executive board is composed of senior executives and inside directors, and is primarily responsible for managing the company. The supervisory board, on the other hand, is typically composed of outside directors who represent shareholders, employers, and lenders, and appoints and oversees the activities of the executive board.

c. An oversight board system where the board of directors appoints management and oversees its activities (U.S.).

7. Compare and contrast rules-based versus principles-based approaches of corporate governance.

The rules-based approach to corporate governance is where corporate governance reforms and listing standards are very rigid and applicable to all listed companies, detailing requirements for compliance and prescribed to a set of rules. On the other hand, the principles-based approach is where corporate governance principles establish benchmarks and norms for good governance practices but companies establish their own corporate governance rules tailored to their circumstances with adequate flexibility to set their own rules. The principles-based approach may create more room for manipulation and even noncompliance with minimum standards.

True or False

1. CEO and chairperson duality can best prevent agency problems and help reinforce the independent nature of the board of directors.
2. Corporations affected by the Combined Code are required to conform and explain their compliance or noncompliance to shareholders.
3. The German board of directors consists of two boards: the management board and the supervisory board.
4. Hostile takeovers are more likely to occur in Germany versus the United States.
5. Japanese corporate culture is dominated by a single organization, the Keiretsu.
6. Lifelong employment is a characteristic of the labor market in Japan.
7. Canadian corporate ownership is much like the United States in that ownership is widely held by many investors.

True or False

1. False
2. True
3. True
4. False
5. False
6. True
7. False

Multiple Choice

1. The network of organizations that shapes the business structure and dominates business practice in Japan is the:

a. Iinkai-to-secchi-kaisha.
b. Keiretsu.
c. Shinobu.
d. Sikkoyaku.

2. The goal of unifying U.S. GAAP and IFRS is referred to as:

a. Comparability.
b. Congruence.
c. Convergence.
d. Containment.

3. A two-tier board of directors system consisting of a management board and a supervisory board best describes the governance structure of:

a. The United States.
b. Germany.
c. The United Kingdom.
d. Japan.

4. Corporate governance reforms clearly separate the board's oversight function from managerial functions in:

a. The United States.
b. Germany.
c. The United Kingdom.
d. Japan.

5. Directors are responsible for the preparation of financial statements and review of internal controls in:

a. Germany.
b. Canada.
c. The United Kingdom.
d. None of the above.

6. Financial institutions play the largest role in corporate governance structure and monitoring in:

a. The United States.
b. Japan.
c. The United Kingdom.
d. Korea.

Multiple Choice

1. b.
2. c.
3. b.
4. a.
5 c.
6. b.

Chapter 15

Review Questions

1. **What are the four levels of legislation process set forth by the Financial Services Action Plan (FSAP)?**
   - Level 1: Framework principles that are initiated by the EC and adopted into legislation by both the Council Ministers and European Parliament.

- Level 2: Community legislation that is adopted by the EU based on technical advice by the Committee of European Securities Regulators (CESR) and approval of member states.
- Level 3: Day-to-day implementation through CESR's guidance.
- Level 4: Review by the EC to ensure compliance with EU legislation by member states.

2. What is the purpose of the financial markets regulatory global dialogue that has been established between the European Commission and the United States?

- Working towards a more efficient transatlantic financial market to enhance sustainable economic growth in the U.S. and Europe.
- Promoting integration of global financial markets.

3. What is the benefit to institutional investors in supporting the e-proxy?

It would make challenging nomination campaigns more feasible and affordable.

4. What are the areas of business practices of private companies in which SOX has led to improvements?

- Stock markets are up since the passage of SOX in July 2002.
- Mergers and acquisitions have substantially increased.
- Initial public offerings (IPOs) have increased.
- New listings on the NYSE have increased.
- New listings on Nasdaq have increased.
- Market capitalization on the NYSE and Nasdaq increased.
- The loan markets have significantly improved since 2002.
- Public company bankruptcies have dropped substantially.

5. What is the Enhanced Business Reporting Consortium (EBRC)?

It is in the process of trying to develop a voluntary, global disclosure framework for EBR that will provide structure for the presentation of financial and nonfinancial KPIs.

6. Explain how the FASB and the IASB have made convergence of accounting standards possible to a certain extent.

- Agreeing to conduct their major accounting standard projects jointly.
- Convincing the SEC to allow foreign companies to use IFRS to raise capital in the United States without having to reconcile them to U.S. GAAP.

7. What do you mean by internal control over financial reporting?

A process to provide reasonable assurance regarding the reliability of financial reporting and the presentations of financial statements for external purposes in accordance with GAAP.

8. Explain the objective of an integrated audit on XBRL-generated financial statements.

- The effectiveness of both the design and operation of internal controls over XBRL-generated financial reports.
- Fair presentation of XBRL-generated financial statements in conformity with the selected XBRL taxonomy.

9. What are the emerging auditing issues in the post-SOX period?

- The expectation gap.
- Auditor switches.

- Auditor independence.
- Auditor resignation.
- Auditor liability.
- Integrated audit approach.
- Engagement letters.
- Audit failure.
- Confirmations.

Discussion Questions

1. Identify and discuss the key emerging corporate governance issues.

- Global market and investor confidence.
- The corporate governance structure including shareholder democracy and director independence.
- Internal controls and risk management including Section 404 compliance.
- Financial reporting including convergence in standards and stock option expensing, pension liability recognition, electronic financial reporting, and financial reporting disclosure.
- Audit function including an integrated audit approach, liability caps, and auditing for fraud.

2. Keeping in mind the number of scandals that have come up in recent years, do you think regulators worldwide coming together and working to enhance the integrity and efficiency of global markets will help? Explain your answer.

Erosion in investor confidence worldwide has been attributed to the fear of terrorist attacks, the economic downturn in many countries, instability in the governments of some countries, and the bad news of pervasive global financial scandals. Accurate and reliable financial information assists investors to make informed and sound investment decisions whereas inaccurate financial information is likely to mislead them into making wrong decisions. Initiatives taken to restore investor confidence in capital markets and financial reports are: (1) more emphasis on corporate codes of ethics; (2) more effective internal control systems; (3) more focus on long-term performance that creates sustainable shareholder value; (4) linking executive compensation to long-term performance; and (5) improving the quality and objectivity of audit services.

3. Global corporate governance can be classified into three general categories of "close," "open," and "hybrid." Discuss the characteristics of these three categories.

The close model of corporate governance is characterized by: (1) concentration of ownership of both equity capital and debt capital; (2) a long-term financing relationship with a few borrowers and lenders; (3) less dependence on capital markets for financing activities; (4) more direct control and management by a few major investors such as banks, insurance, or individuals; (5) more direct and close oversight function by monitoring bodies such as supervisory boards; (6) a well-balanced distribution of control rights and information rights; (7) less information asymmetry between management, the supervisory board, and major investors; and (8) more focus on internal information flows and controls. An example of a close model, which is also referred to as "insider control," is German corporate governance.

The open model of corporate governance, better known as the "market-based" or "outsider" model, is characterized by: (1) total reliance on capital markets for sources of financing activities (both equity capital and debt capital); (2) less concentration of ownership in the hands of a few major investors; (3) an oversight function by the board of directors; (4) less regulation of corporate governance and corporate activities; (5) total separation of the managerial function and oversight function; (6) existence of a market-based system of checks and balances; (7) information asymmetry between management, the board of directors, and investors; and (8) more focus on external information flows and controls. A purely market-based corporate governance model does not exist from a practical perspective or in a real-world environment. The hybrid model encompasses a combination of market-based mechanisms, internal mechanisms, and regulatory mechanisms. The closest to the market-based model is the corporate governance model in the U.S. In reality the U.S. corporate governance model is a hybrid model based on market-based mechanisms with proper monitoring by governmental regulations.

The hybrid model is a set of both internal and external mechanisms designed to manage, monitor, control, reward, and discipline arrangements among all stakeholders to create sustainable and enduring value and to protect their interests. Stakeholders are broadly defined as those who have contractual relationships with the company, such as investors, creditors, suppliers, customers, employees, and those who affect or are affected by the company's business affairs including social constituents, the community, society at large, local, state, and federal governments, and environmental interests. Companies that do not adopt an effective corporate governance structure would presumably be inefficient and in the long term would be disciplined by the capital markets. Thus, there is no need for policy or governmental interventions because market mechanisms correct any corporate governance inefficiencies. However, recent financial scandals demonstrate that market-correction mechanisms were not adequate by themselves to solve the market failure arising from asymmetric information and potential conflicts of interest among corporate governance participants. Market failures and resulting financial scandals provide justifiable grounds for policy intervention to prevent management from adopting a suboptimal level of corporate governance.

Thus, an effective corporate governance structure depends on a well-balanced relation between internal mechanisms, external mechanisms, and policy, regulatory, and legal requirements.

4. The framework of corporate governance reporting and assurance is suggested by the Global Reporting Initiatives (GRI). Describe the GRI guidelines for corporate governance reporting.

GRI guidelines consist of five components: (1) the introduction which describes the motivation for and benefits of sustainability reporting; (2) part two which provides basic information regarding the nature of the guidelines, their documentation, design, and reporting expectations; (3) part three consisting of reporting principles which describe the principle of sustainability performance; (4) part four consisting of reporting content, providing detailed information about the content of a GRI report; and (5) the final part consisting of glossary and annexes, giving background information about the GRI and supplemental information pertaining to the preparation of GRI reports and assurance provided on such reports.

5. Explain why the trend toward emphasis on social, ethical, and environmental issues will continue to increase.

There has been a growing interest in social, ethical, and environmental (SEE) measures and performances in addition to economic performance. Companies worldwide disclose whether their board has: (1) recognized the significance of SEE matters; (2) considered the significant risks and opportunities provided by appropriate responses to SEE matters; (3) obtained adequate information to assess the importance of SEE matters; (4) established appropriate policies to manage risks to short- and long-term value resulting from SEE issues; and (5) provided sufficient measure of the company's SEE performance.

6. Identify and describe factors that may influence the future of financial reporting.

The current financial reporting system based on a rules-based approach in measuring, recognizing, and disclosing financial information has less value-relevance to investors and is more complicated and costly than it should be.

Several drivers of an enhanced future financial reporting process are:

1. Globalization—The move toward convergence in accounting and auditing standards and globally accepted accounting principles in compliance with IFRS. (The SEC is already accepting financial statements prepared in conformity with IFRS for foreign private issuers without the need for reconciliation to U.S. GAAP.)
2. Technological advances—The use of XBRL format in financial reporting.
3. Investors' need for more sustainable information on both financial and nonfinancial KPIs.
    a. Stop quarterly earnings guidance which forces management to focus on short-term performance at the expense of long-term sustainable performance.
    b. Focus on value drivers and MBL performance in the areas of economic, governance, social, ethical, and environmental activities.
    c. Focus on forward-looking financial information.

    d. Link reasonable executive compensation to long-term strategic and sustainable performance.
4. Integrated reporting of financial statements and internal controls.
5. Intangibles including the value of the company's brand and its relationship with employees, suppliers, and customers that drive value creation, which should be properly measured, recognized, and disclosed.
6. Fewer rules and better judgments for accruals and estimates.

7. Discuss the extent to which convergence between U.S. GAAP and IFRS is possible.

IFRS is viewed as principles-based requiring fair and true presentation of financial reports compared with U.S. GAAP, which is regarded as rules-based and requiring fair presentation of financial reports. Compliance with U.S. GAAP by public companies is required by the 1934 Securities Exchange Act. Convergence in accounting standards means that standard setters (e.g., FASB, IASB) worldwide agree to eliminate differences in how similar transactions are processed with the keen objective of establishing confidence in the quality of global financial reporting. Progress has been made toward reconciliation and harmonization of accounting standards worldwide, and short-term projects are being undertaken to remove a variety of differences between IFRS and U.S. GAAP. The SEC has recently eliminated reconciliation requirements to U.S. GAAP for foreign registrants that comply with IFRS and is considering an initiative to allow even U.S. companies to comply with IFRS for their SEC filing purposes. These are positive steps toward complete convergence between U.S. GAAP and IFRS.

8. Discuss the possibility of convergence in auditing standards.

Consolidated financial statements of SEC-registered companies are required to be audited by an independent auditor in accordance with auditing standards established by the PCAOB. European countries comply with International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). It is expected that both auditing standards and audit regulations throughout the world will remain on a national level.

True or False

1. Corporate governance reporting changes companies' one-dimensional financial reporting to multidimensional bottom lines.
2. Sustainability reports are uniform with assurance provided on their completeness and reliability.
3. According to anecdotal evidence improvements in corporate governance are not associated with improvements in corporate performance.
4. Before an issuing company registers with the SEC, regulations prohibit the company from conducting promotions that may boost its stock price.
5. E-proxy may result in lower costs for investor-to-investor communications.
6. A promanagement summary postcard has the potential of driving down turnout or encouraging automatic "yes" voting in contentious annual general meetings.
7. In the post-SOX era, the representation of members of racial minorities and women in management positions is still disproportionably low.

8. According to the Protection against Executive Compensation Abuse Act shareholder approval is not required for the company's executive compensation plan.
9. Section 162(m) of the 1993 tax code allowed companies to deduct executive compensation in excess of $1,000,000 for federal tax purposes unless it is performance-based.
10. Private companies are currently required to comply with corporate governance and financial reporting.
11. Financial restatements are a major contributing factor in eroding investor confidence and public trust in public financial information.
12. The EU Accounts Modernisation Directive (EU AMD) requires decreasing the comparability between European companies through a common reporting framework.
13. Antifraud prevention and detection controls and assessments addressed by SOX are relevant only to financial statement fraud.
14. Audit failure of not discovering and reporting material misstatements in financial statements can increase the chance of reporting failure of misstating financial statements.

True or False

1. True
2. False
3. False
4. True
5. False
6. True
7. True
8. False
9. True
10. False
11. True
12. False
13. True
14. True

Multiple Choice Questions

1. GRI focuses on three sustainability dimensions of:
   a. Economic.
   b. Ethical.
   c. Governance.
   d. None of the above.

2. The structure of corporate governance of companies in terms of the percentage of ownership of blockholders and outside directors on the board can change:
   a. When the company files the IPO.
   b. After the company is past the IPO stage.
   c. When the stock prices go high.
   d. When it decides to go public.

3. Which of the following is not allowed by the SEC proposed proxy access rule:

a. Allowing small shareholders of shareholder groups access to companies' proxy statements to nominate their director candidates.
b. Enabling selected shareholders to nominate their candidates.
c. Granting shareholders access and the right to nominate directors under circumstances in which a "triggering event" has occurred.
d. None of the above.

4. In which of the following circumstances is democratic voting not practiced:

a. When directors are elected despite an overwhelming majority of opposing votes.
b. When brokers can vote for management in place of silent shareholders.
c. Both (a) and (b).
d. Neither (a) nor (b).

5. Which if the following is not a feature of plurality voting:

a. Nominated candidates can vote for themselves.
b. A single affirmative vote is not sufficient for a director to be elected.
c. The nominating committee provides shareholders with the option of voting for nominees or choosing not to vote at all.
d. The majority of shareholders, up to 99 percent, can vote against a nominee and he or she can still be elected.

6. Most individual/retail investors do not want e-proxy because of:

a. Security concerns of financial information over the Internet.
b. The ease of reading materials on a computer screen.
c. Having Internet access at all times.
d. None of the above.

7. More effective shareholder democracy can affect which of the following:

a. Increase market mechanisms for corporate control.
b. Increase management entrenchment devices.
c. No power to elect independent directors.
d. All of the above.

8. To increase accountability in the boardroom and improve the effectiveness of board committees, companies are changing their compensation policies and practices by:

a. Paying per meeting fees to members of board committees.
b. Increasing the use of restricted and deferred stock.
c. Both (a) and (b).
d. Neither (a) nor (b).

9. Section 408 of SOX requires the SEC to review financial reports filed with the commission by public companies at least every:

a. Four years.
b. Two years.
c. Three years.
d. Five years.

10. International Financial Reporting Standards are regarded as:

a. Principles-based standards.
b. Rules-based standards.
c. Both (a) and (b).
d. Neither (a) nor (b).

11. Which of the following sections of SOX requires public companies to disclose their financial reports on a rapid and current basis:

a. Section 409.
b. Section 302.
c. Section 162.
d. Section 401.

12. Integrated audit covers the audit of:

a. Internal control over financial reporting.
b. Internal control over audit of financial statements.
c. Internal control over financial reporting and financial statements.
d. Internal control neither over financial reporting nor over audit of financial statements.

13. Which of the following sections of SOX directs the Government Accountability Office (GAO) to study the factors contributing to consolidation in public accounting firms in the 1980s and 1990s in the United States:

a. Section 401.
b. Section 302.
c. Section 409.
d. Section 701.

Multiple Choice Questions

1. a. .
2. b.
3. a.
4. c.
5. b.
6. a.
7. a.
8. c.
9. c.
10. a.
11. a.
12. c.
13. d.