Since a corporation is a legal entity, the profits or losses are treated as a separate entity on an income tax return. The owners are not taxed until profits are distributed to the owners (dividends). In the United States, some corporations qualify to be treated as a subchapter S corporation. These corporations do not pay a corporate income tax. The profits or losses go directly on the income tax returns of the owners.

In the United States, most businesses operate as proprietorships, but corporations perform the bulk of business activity. Since the bulk of business activity is carried on in corporations and because much of financial accounting is concerned with reporting to the public, this book focuses on the corporate form of business.

Accounting for corporations, sole proprietorships, and partnerships is the same, except for the owners' equity section of the balance sheet. The owners' equity section for a sole proprietorship consists of the owners' capital account, while the owners' equity section for a partnership has a capital account for each partner. The more complicated owners' equity section for a corporation will be described in detail in this book.

The Financial Statements

The principal financial statements of a corporation are the balance sheet, income statement, and statement of cash flows. Notes accompany these financial statements. To evaluate the financial condition, the profitability, and cash flows of an entity, the user needs to understand the statements and related notes.

Exhibit 2-1 illustrates the interrelationship of the balance sheet, income statement, and statement of cash flows. The most basic statement is the balance sheet. The other statements explain the changes between two balance sheet dates.

Balance Sheet (Statement of Financial Position)

A balance sheet shows the financial condition of an accounting entity as of a particular date. The balance sheet consists of three major sections: assets, the resources of the firm; liabilities, the debts of the firm; and stockholders' equity, the owners' interest in the firm.

At any point in time, the total assets amount must equal the total amount of the contributions of the creditors and owners. This is expressed in the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

In simplistic form, the stockholders' equity of a corporation appears as follows:

Stockholders' Equity	
Common stock	$200,000
Retained earnings	50,000
	$250,000

This indicates that stockholders contributed (invested) $200,000, and prior earnings less prior dividends have been retained in the entity in the net amount of $50,000 (retained earnings).

Statement of Stockholders' Equity (Reconciliation of Stockholders' Equity Accounts)

Firms are required to present reconciliations of the beginning and ending balances of their stockholders' equity accounts. This is accomplished by presenting a "statement of stockholders' equity." Retained earnings is one of the accounts in stockholders' equity.

Retained earnings links the balance sheet to the income statement. Retained earnings is increased by net income and decreased by net losses and dividends paid to stockholders. There are some other possible increases or decreases to retained earnings besides income (losses) and dividends. For the purposes of this chapter, retained earnings will be described as prior earnings less prior dividends.

Exhibit 2-1 ABC COMPANY

The Interrelationship of Financial Statements

Balance Sheet
December 31, 2008

Assets	
Cash	$25,000
Receivables	20,000
Inventory	30,000
Land	10,000
Other assets	10,000
Total assets	$95,000
Liabilities	
Accounts payable	$25,000
Wages payable	5,000
Total liabilities	30,000
Stockholders' Equity	
Capital stock	40,000
Retained earnings	25,000
Total stockholders' equity	65,000
Total liabilities and stockholders' equity	$95,000

Statement of Cash Flows
For the Year Ended Dec. 31, 2009

Cash flow from operating activities:	
Net Income	$ 20,000
+ Decrease in inventory	10,000
– Decrease in accounts payable	(5,000)
Net cash flow from operating activities	25,000
Cash flow from investing activities:	
– Increase in land	(10,000)
Net cash flow from investing activities	(10,000)
Cash flow from financing activities:	
+ Capital stock	10,000
– Dividends	(10,000)
Net cash flow from financing activities	0
Net increase in cash	15,000
Cash at beginning of year	25,000
Cash at end of year	$ 40,000

Income Statement
For the Year Ended Dec. 31, 2009

Revenues	$ 120,000
– Expenses	(100,000)
Net income	$ 20,000

Statement of Retained Earnings
For the Year Ended Dec. 31, 2009

Beginning balance	$ 25,000
+ Net income	20,000
– Dividends	(10,000)
Ending balance	$ 35,000

Balance Sheet
December 31, 2009

Assets	
Cash	$ 40,000
Receivables	20,000
Inventory	20,000
Land	20,000
Other assets	10,000
Total assets	$110,000
Liabilities	
Accounts payable	$ 20,000
Wages payable	5,000
Total liabilities	25,000
Stockholders' Equity	
Capital stock	50,000
Retained earnings	35,000
Total stockholders' equity	85,000
Total liabilities and stockholders' equity	$110,000

Firms usually present the reconciliation of retained earnings within a "statement of stockholders' equity." Some firms present the reconciliation of retained earnings at the bottom of the income statement (combined income statement and retained earnings). In this case, the other stockholders' equity accounts may be reconciled in a statement that excludes retained earnings. An additional review of the statement of stockholders' equity is in Chapter 3.

Income Statement (Statement of Earnings)

The **income statement** summarizes revenues and expenses and gains and losses, ending with net income. It summarizes the results of operations for a particular period of time. Net income is included in retained earnings in the stockholders' equity section of the balance sheet. (This is necessary for the balance sheet to balance.)

Statement of Cash Flows (Statement of Inflows and Outflows of Cash)

The **statement of cash flows** details the inflows and outflows of cash during a specified period of time—the same period that is used for the income statement. The statement of cash flows consists of three sections: cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities.

Notes

The notes to the financial statements are used to present additional information about items included in the financial statements and to present additional financial information. Notes are an integral part of financial statements. A detailed review of notes is essential to understanding the financial statements.

Certain information must be presented in notes. Accounting policies are to be disclosed as the first note or be disclosed in a separate summary of significant accounting policies (preceding the first note). Accounting policies include such items as the method of inventory valuation and depreciation policies. Other information specifically requiring note disclosure is the existence of contingent liabilities and some subsequent events.

Contingent liabilities are dependent upon the occurrence or nonoccurrence of one or more future events to confirm the liability. The settlement of litigation or the ruling of a tax court would be examples of the confirmation of a contingent liability. Signing as guarantor on a loan creates another type of contingent liability.

An estimated loss from a contingent liability should be charged to income and be established as a liability only if the loss is considered probable and the amount is reasonably determinable. A contingent liability that is recorded is also frequently described in a note. A loss contingency that is reasonably possible, but not probable, must be disclosed even if the loss is not reasonably estimable. (This loss contingency is not charged to income or established as a liability.) A loss contingency that is less than reasonably possible does not need to be disclosed, but disclosure may be desirable if there is an unusually large potential loss. Exhibit 2-2 illustrates a contingent liability note for Intel Corporation whose fiscal year ended December 30, 2006.

***Exhibit* 2-2** INTEL CORPORATION*

For the Fiscal Year Ended December 30, 2006
Contingences (in Part)

Tax Matters

In connection with the regular examination of Intel's tax returns for the years 1999 through 2005, the IRS formally assessed, in 2005 and 2006, certain adjustments to the amounts reflected by Intel on those returns as a tax benefit for its export sales. The company does not agree with these adjustments and has appealed the assessments. If the IRS prevails in its position, Intel's federal income tax due for 1999 through 2005 would increase by approximately $2.2 billion, plus interest. In addition, the IRS will likely make a similar claim for 2006, and if the IRS prevails, income tax due for 2006 would increase by approximately $200 million, plus interest.

Although the final resolution of the adjustments is uncertain, based on currently available information, management believes that the ultimate outcome will not have a material adverse effect on the company's financial position, cash flows, or overall trends in results of operations. There is the possibility of a material adverse impact on the results of operations for the period in which the matter is ultimately resolved, if it is resolved unfavorably, or in the period in which an unfavorable outcome becomes probable and reasonably estimable.

*"We are the world's largest semiconductor chip maker, based on revenue." 10-K

Subsequent events occur after the balance sheet date, but before the statements are issued. Two varieties of subsequent events occur. The first type consists of events related to conditions that existed at the balance sheet date, affect the estimates in the statements, and require adjustment of the statements before issuance. For example, if additional information is obtained indicating that a major customer's account receivable is not collectible, an adjustment would be made. The second type consists of events that provide evidence about conditions that did not exist at the balance sheet date and do not require adjustment of the statements. If failure to disclose these events would be misleading, disclosure should take the form of notes or supplementary schedules. Examples of the second type of such events include the sale of securities, the settlement of litigation, or casualty loss. Other examples of subsequent events might be debt incurred, reduced, or refinanced; business combinations pending or effected; discontinued operations; employee benefit plans; and capital stock issued or purchased. Exhibit 2-3 describes a subsequent event for Kellogg Company, whose year-end was December 30, 2006.

Exhibit 2-3 KELLOGG COMPANY*

For the Fiscal Year Ended December 30, 2006

Subsequent Events

As discussed in preceding subnote (d), on January 31, 2007, a subsidiary of the Company announced an early redemption, effective February 28, 2007, of Euro 550 million of Guaranteed Floating Rate Notes otherwise due May 2007. To partially refinance this redemption, the Company and two of its subsidiaries (the "Issuers") established a program under which the Issuers may issue euro-commercial paper notes up to a maximum aggregate amount outstanding at any time of $750 million or its equivalent in alternative currencies. The notes may have maturities ranging up to 364 days and will be senior unsecured obligations of the applicable issuer. Notes issued by subsidiary Issuers will be guaranteed by the Company. The notes may be issued at a discount or may bear fixed or floating rate interest or a coupon calculated by reference to an index or formula.

In connection with these financing activities, the Company increased its short-term lines of credit from $2.2 billion at December 30, 2006 to approximately $2.6 billion, via a $400 million unsecured 364-Day Credit Agreement effective January 31, 2007. The 364-Day Agreement contains customary covenants, warranties, and restrictions similar to those described herein for the Five-Year Credit Agreement. The facility is available for general corporate purposes, including commercial paper back-up, although the Company does not currently anticipate any usage under the facility.

*"Kellogg Company, founded in 1906 and incorporated in Delaware in 1922, and its subsidiaries are engaged in the manufacture and marketing of ready-to-eat cereal and convenience foods." 10-K

The Accounting Cycle

The sequence of accounting procedures completed during each accounting period is called the accounting cycle. A broad summary of the steps of the accounting cycle includes:

1. Recording transactions
2. Recording adjusting entries
3. Preparing the financial statements

Recording Transactions

A **transaction** is an event that causes a change in a company's assets, liabilities, or stockholders' equity, thus changing the company's financial position. Transactions may be external or internal to the company. External transactions involve outside parties, while internal transactions are confined within the company. For example, sales is an external transaction, while the use of equipment is internal.

Transactions must be recorded in a **journal** (book of original entry). All transactions could be recorded in the general journal. However, companies use a number of special journals to record most transactions. The special journals are designed to improve record-keeping efficiency that could not be obtained by using only the general journal. The general journal is then used only to record transactions for which the company does not have a special journal. A transaction recorded in a journal is referred to as a **journal entry**.

All transactions are recorded in a journal (journal entry) and are later posted from the journals to a **general ledger** (group of accounts for a company). After posting, the general ledger accounts contain the same information as the journals, but the information has been summarized by account.

Accounts store the monetary information from the recording of transactions. Examples of accounts include Cash, Land, and Buildings. An accounting system can be computerized or manual. A manual system using T-accounts is usually used for textbook explanations because a T-account is a logical format.

T-accounts have a left (debit) side and a right (credit) side. An example T-account follows:

Cash	
Debit	Credit

A double-entry system has been devised to handle the recording of transactions. In a double-entry system, each transaction is recorded with the total dollar amount of the debits equal to the total dollar amount of the credits. The scheme of the double-entry system revolves around the **accounting equation**:

Assets = Liabilities + Stockholders' Equity

With the double-entry system, *debit* merely means the left side of an account, while *credit* means the right side. Each transaction recorded must have an equal number of dollars on the left side as it does on the right side. Several accounts could be involved in a single transaction, but the debits and credits must still be equal.

The debit and credit approach is a technique that has gained acceptance over a long period of time. This book will not make you competent in the use of the double-entry (debit and credit) technique. It will enhance your understanding of the end result of the accounting process and enable you to use the financial accounting information in a meaningful way.

Asset, liability, and stockholders' equity accounts are referred to as **permanent accounts** because the balances in these accounts carry forward to the next accounting period. Balances in revenue, expense, gain, loss, and dividend accounts, described as **temporary accounts**, are closed to retained earnings and not carried into the next period.

Exhibit 2-4 illustrates the double-entry system. Notice that the permanent accounts are represented by the accounting equation: assets = liabilities + stockholders' equity. The temporary accounts are represented by revenue, expense, and dividends. (Gains and losses would be treated like revenue and expense, respectively.) The balance sheet will not balance until the temporary accounts are closed to retained earnings.

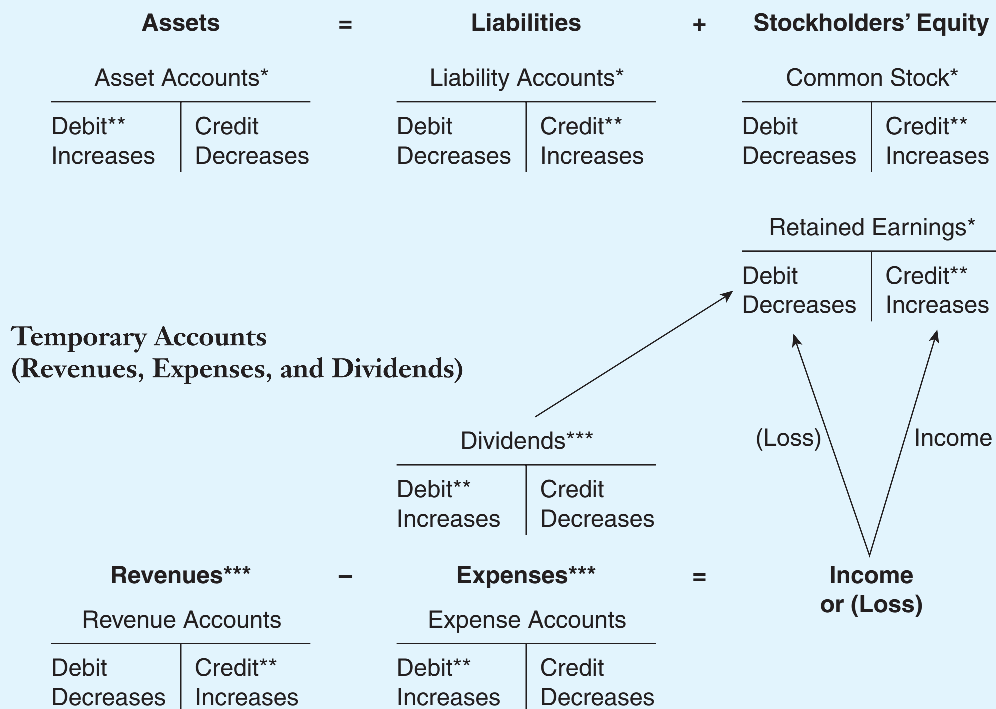
Recording Adjusting Entries

Earlier, a distinction was made between the accrual basis of accounting and the cash basis. It was indicated that the accrual basis requires that revenue be recognized when realized (realization concept) and expenses recognized when incurred (matching concept). The point of cash receipt for revenue and cash disbursement for expenses is not important under the accrual basis when determining income. Usually, a company must use the accrual basis to achieve a reasonable result for the balance sheet and the income statement.

The accrual basis needs numerous adjustments to account balances at the end of the accounting period. For example, $1,000 paid for insurance on October 1 for a one-year period (October 1–September 30) could have been recorded as a debit to Insurance Expense ($1,000) and a credit to Cash ($1,000). If this company prepares financial statements on December 31, it would be necessary to adjust Insurance Expense because not all of the insurance expense should be recognized in the three-month period October 1–December 31. The adjustment would debit Prepaid Insurance, an asset account, for $750 and credit

Exhibit 2-4 DOUBLE-ENTRY SYSTEM

(Illustrating Relationship Between Permanent and Temporary Accounts)



* Permanent accounts
** Normal balance
*** Temporary accounts

Insurance Expense for $750. Thus, insurance expense would be presented on the income statement for this period as $250, and an asset, prepaid insurance, would be presented on the balance sheet as $750.

Adjusting entries are recorded in the general journal and then posted to the general ledger. Once the accounts are adjusted to the accrual basis, the financial statements can be prepared.

Preparing the Financial Statements

The accountant uses the accounts after the adjustments have been made to prepare the financial statements. These statements represent the output of the accounting system. Two of the principal financial statements, the income statement and the balance sheet, can be prepared directly from the adjusted accounts. Preparation of the statement of cash flows requires further analysis of the accounts.

Treadway Commission

Treadway Commission is the popular name for the National Commission on Fraudulent Reporting named after its first chairman, former SEC Commissioner James C. Treadway. The Commission has issued a number of recommendations for the prevention of fraud in financial reports, ethics, and effective internal controls. The Treadway Commission is a voluntary private-sector organization formed in 1985.[1]

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has released reports detailing internal control systems. These reports represent the standard for evaluating the effectiveness of internal control systems.

Section 404 of the Sarbanes-Oxley Act emphasizes the importance of internal control and makes management responsible for internal controls. The independent public accounting firm is required to give an opinion as to management's assessment of internal control and the effectiveness of internal control over financial reporting as of the balance sheet date.

The Management's Report on Internal Control over Financial Reporting and the independent public accounting firm report to the shareholders, and the board of directors often refers to the criteria established on internal control by COSO.

Auditor's Opinion

An auditor (certified public accountant) conducts an independent examination of the accounting information presented by the business and issues a report thereon. An auditor's report is the formal statement of the auditor's opinion of the financial statements after conducting an audit. Audit opinions are classified as follows:

1. **Unqualified opinion.** This opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity, in conformity with generally accepted accounting principles.
2. **Qualified opinion.** A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity, in conformity with generally accepted accounting principles.
3. **Adverse opinion.** This opinion states that the financial statements do *not* present fairly the financial position, results of operations, and cash flows of the entity, in conformity with generally accepted accounting principles.
4. **Disclaimer of opinion.** A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. A disclaimer of opinion is rendered when the auditor has not performed an audit sufficient in scope to form an opinion.

Since the passage of Sarbanes-Oxley, the form of the audit opinion can vary substantially. Private companies are not under Sarbanes-Oxley, but an increasing number of private companies are complying with parts of the law. Some of the reasons for private companies to follow the law are the following:

1. Owners hope to sell the company or take it public.
2. Directors who sit on public-company boards see the law's benefits.
3. Executives believe strong internal controls will improve efficiency.
4. Customers require strong internal controls.
5. Lenders are more likely to approve loans.[2]

The typical unqualified (or clean) opinion for private companies has three paragraphs. The first paragraph indicates that the financial statements have been audited and are the responsibility of the company's management. This paragraph states that the auditors have the responsibility to either express an opinion on these statements based on the audit or to disclaim an opinion.

The second paragraph indicates that the audit has been conducted in accordance with generally accepted auditing standards. This will typically be expressed in terms of standards of the Public Company Accounting Oversight Board (United States). These standards require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. This paragraph also confirms that the audit provided a reasonable basis for an opinion.

The third paragraph gives an opinion on the statements—that they are in conformity with GAAP. In certain circumstances, an unqualified opinion on the financial statements may require that the auditor add an explanatory paragraph after the opinion paragraph. In this paragraph, the auditor may express agreement with a departure from a designated principle, describe a material uncertainty, describe a change in accounting principle, or express doubt as to the ability of the entity to continue as a going concern. An explanatory paragraph may also be added to emphasize a particular matter.

The audit opinion of a public company is similar to an opinion for a private company except that the public company comments will be added as to the effectiveness of internal control over financial reporting. An opinion is expressed as to management's assessment of, and the effective operation of, internal control over financial reporting.

When examining financial statements, review the independent auditor's report. It can be important to your analysis. From the point of view of analysis, financial statements accompanied by an unqualified opinion without an explanatory paragraph or explanatory language carry the highest degree of reliability. This type of report indicates that the financial statements do not contain a material departure from GAAP and that the audit was not limited as to scope.

When an unqualified opinion contains an explanatory paragraph or explanatory language, try to decide how seriously to regard the departure from a straight unqualified opinion. For example, an explanatory paragraph because of a change in accounting principle would not usually be regarded as serious, although it would be important to your analysis. An explanatory paragraph because of a material uncertainty would often be regarded as a serious matter.

You are likely to regard a qualified opinion or an adverse opinion as casting serious doubts on the reliability of the financial statements. In each case, you must read the auditor's report carefully to form your opinion.

A disclaimer of opinion indicates that you should not look to the auditor's report as an indication of the reliability of the statements. When rendering this type of report, the auditor has not performed an audit sufficient in scope to form an opinion, or the auditor is not independent.

In some cases, outside accountants are associated with financial statements when they have performed less than an audit. The accountant's report then indicates that the financial statements have been reviewed or compiled.

A **review** consists principally of inquiries made to company personnel and analytical procedures applied to financial data. It has substantially less scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, the accountant does not express an opinion. The accountant's report will indicate that the accountants are not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with GAAP; or the report will indicate departures from GAAP. A departure from GAAP may result from using one or more accounting principles without reasonable justification, the omission of necessary note disclosures, or the omission of the statement of cash flows.

In general, the reliance that can be placed on financial statements accompanied by an accountant's review report is substantially less than those accompanied by an audit report. Remember that the accountant's report does not express an opinion on reviewed financial statements.

When the outside accountant presents only financial information as provided by management, he or she is said to have **compiled** the financial statements. The compilation report states that the accountant has not audited or reviewed the financial statements. Therefore, the accountant does not express an opinion or any other form of assurance about them. If an accountant performs a compilation and becomes aware of deficiencies in the statements, then the accountant's report characterizes the deficiencies as follows:

- Omission of substantially all disclosures
- Omission of statement of cash flows
- Accounting principles not generally accepted

Sometimes financial statements are presented without an accompanying accountant's report. This means that the statements have not been audited, reviewed, or compiled. Such statements are solely the representation of management.

Auditor's Report on the Firm's Internal Controls

For public companies reporting under Sarbanes-Oxley, a report on the firm's internal controls is required in addition to the audit report. The internal control report is usually much longer than the audit report. For some firms, the audit opinion and the report on the firm's internal controls have been combined. This results in one audit report that can be very long.

Exhibit 2-5 presents the audit report for T. Rowe Price Group, Inc. It is an unqualified opinion. T. Rowe Price Group, Inc., is a public company reporting under Sarbanes-Oxley. Exhibit 2-6 presents the auditor's report on T. Rowe Price Group, Inc.'s internal controls.

Exhibit 2-5 T. ROWE PRICE GROUP, INC.*

Audit Opinion
Unqualified Opinion—2006 Annual Report

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
T. Rowe Price Group, Inc.

We have audited the accompanying consolidated balance sheets of T. Rowe Price Group, Inc. and subsidiaries ("the Company") as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of T. Rowe Price Group, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in the summary of significant accounting policies accompanying the consolidated financial statements, effective January 1, 2006, the Company changed its method of accounting for stock-based compensation with the adoption of Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 7, 2007, expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

Baltimore, Maryland
February 7, 2007

*"T. Rowe Price Group is a financial services holding company that derives its consolidated revenues and net income primarily from investment advisory services that its subsidiaries provide to individual and institutional investors in the sponsored T. Rowe Price mutual funds and other investment portfolios." 10-K

Exhibit 2-6 T. ROWE PRICE GROUP, INC.*

Auditor's Report on the Firm's Internal Controls–2006 Annual Report

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
T. Rowe Price Group, Inc.

We have audited management's assessment, included in the accompanying Report on Internal Control Over Financial Reporting, that T. Rowe Price Group, Inc. and subsidiaries ("the Company") maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

*"T. Rowe Price Group is a financial services holding company that derives its consolidated revenues and net income primarily from investment advisory services that its subsidiaries provide to individual and institutional investors in the sponsored T. Rowe Price mutual funds and other investment portfolios." 10-K

(continued)

Exhibit 2-6 T. ROWE PRICE GROUP, INC. (Continued)

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of T. Rowe Price Group, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated February 7, 2007, expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Baltimore, Maryland
February 7, 2007

Report of Management on Internal Control over Financial Reporting

Under Sarbanes-Oxley, management of public companies must present a Report of Management on Internal Control over Financial Reporting. Exhibit 2-7 presents the internal control report of management for T. Rowe Price Group, Inc., that was presented with its 2006 annual report.

Management's Responsibility for Financial Statements

The responsibility for the preparation and for the integrity of financial statements rests with management. The auditor is responsible for conducting an independent examination of the statements and expressing an opinion on the financial statements based on the audit. To make financial statement users aware of management's responsibility, some companies have presented management statements to shareholders as part of the annual report. Exhibit 2-8 shows an example of a report of management's responsibility for financial statements as presented by Kellogg Company in its 2006 annual report.

The SEC's Integrated Disclosure System

In general, in the United States, the SEC has the authority to prescribe external financial reporting requirements for companies with securities sold to the general public. Under this jurisdiction, the SEC requires that certain financial statement information be included in the annual report to shareholders. This annual report, along with certain supplementary information, must then be included, or incorporated by reference, in the annual filing to the SEC, known as the **10-K report** or **Form 10-K**. The Form 10-K is due 60 days, 75 days, or 90 days following the end of the company's fiscal year, depending on the market value of the common stock (see Exhibit 2-9). The annual report and the Form 10-K include audited financial statements.

The SEC promotes an integrated disclosure system between the annual report and the Form 10-K. The goals are to improve the quality of disclosure, lighten the disclosure load, standardize information requirements, and achieve uniformity of annual reports and Form 10-K filings.

In addition to the company's primary financial statements, the Form 10-K must include the following:

1. Information on the market for holders of common stock and related securities, including high and low sales price, frequency and amount of dividends, and number of shares.
2. Five-year summary of selected financial data, including net sales or operating revenues, income from continuing operations, total assets, long-term obligations, redeemable preferred stock, and cash dividends per share. (Some companies elect to present data for more than five years and/or expand the disclosure.) Trend analysis is emphasized.

Exhibit 2-7 T. ROWE PRICE GROUP, INC.*

Report of Management on Internal Control over Financial Reporting—2006 Annual Report

Report of Management on Internal Control over Financial Reporting

To the Stockholders of T. Rowe Price Group, Inc.

We, together with other members of management of T. Rowe Price Group, are responsible for establishing and maintaining adequate internal control over the company's financial reporting. Internal control over financial reporting is the process designed under our supervision, and effected by the company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the company's financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

There are inherent limitations in the effectiveness of internal control over financial reporting, including the possibility that misstatements may not be prevented or detected. Accordingly, even effective internal controls over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Furthermore, the effectiveness of internal controls can change with circumstances.

Management has evaluated the effectiveness of internal control over financial reporting as of December 31, 2006, in relation to criteria described in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on management's assessment, we believe that the company's internal control over financial reporting was effective as of December 31, 2006.

KPMG LLP, an independent registered public accounting firm, has audited our financial statements that are included in this annual report and expressed an unqualified opinion thereon. KPMG LLP has also expressed an unqualified opinion on management's assessment of, and the effective operation of, our internal control over financial reporting as of December 31, 2006.

February 7, 2007

/s/ James A. C. Kennedy
Chief Executive Officer and President

/s/ Kenneth V. Moreland
Vice President and Chief Financial Officer

*"T. Rowe Price Group is a financial services holding company that derives its consolidated revenues and net income primarily from investment advisory services that its subsidiaries provide to individual and institutional investors in the sponsored T. Rowe Price mutual funds and other investment portfolios." 10-K

3. Management's discussion and analysis (MDA) of financial condition and results of operations. Specifically required is discussion of liquidity, capital resources, and results of operations.
4. Two years of audited balance sheets and three years of audited income statements and statements of cash flow.
5. Disclosure of the domestic and foreign components of pretax income, unless foreign components are considered to be immaterial.

SEC requirements force management to focus on the financial statements as a whole, rather than on just the income statement and operations. Where trend information is relevant, discussion should center on the five-year summary. Emphasis should be on favorable or unfavorable trends and on identification of significant events or uncertainties. This discussion should provide the analyst with a reasonable summary of the position of the firm.

Exhibit 2-8 KELLOGG COMPANY*

Management's Responsibility for Financial Statements—2006 Annual Report

Management's Responsibility for Financial Statements

Management is responsible for the preparation of the Company's consolidated financial statements and related notes. We believe that the consolidated financial statements present the company's financial position and results of operations in conformity with accounting principles that are generally accepted in the United States, using our best estimates and judgments as required.

The independent registered public accounting firm audits the Company's consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board and provides an objective, independent review of the fairness of reported operating results and financial position.

The Board of Directors of the Company has an Audit Committee composed of three non-management Directors. The Committee meets regularly with management, internal auditors, and the independent registered public accounting firm to review accounting, internal control, auditing and financial reporting matters.

Formal policies and procedures, including an active Ethics and Business Conduct program, support the internal controls and are designed to ensure employees adhere to the highest standards of personal and professional integrity. We have a vigorous internal audit program that independently evaluates the adequacy and effectiveness of these internal controls.

*"Kellogg Company, founded in 1906 and incorporated in Delaware in 1922, and its subsidiaries are engaged in the manufacture and marketing of ready-to-eat cereal and convenience foods." 10-K

Exhibit 2-9 FORM 10-K AND 10-Q DEADLINE

Category of Filer	Form 10-K Deadline	Form 10-Q Deadline
Large accelerated filer ($700 million or more market value*)	60 days	40 days
Accelerated filer ($75 million or more and less than $700 million market value*)	75 days	40 days
Non-accelerated filer (less than $75 million market value*)	90 days	45 days

*Market value is the worldwide market value of outstanding voting and non-voting common equity held by non-affiliates.

Source: Adapted from Securities and Exchange Commission Release No. 33-8644, Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, December 21, 2005.

Exhibit 2-10 presents a summary of the major parts of the Form 10-K. In practice, some of the required information in the Form 10-K is incorporated by reference. Incorporated by reference means that the information is presented outside the Form 10-K, and a reference in the Form 10-K indicates where the information can be found.

A review of a company's Form 10-K can reveal information that is not available in the annual report. For example, Item 2 of the Form 10-K reveals a detailed listing of properties and indicates if the property is leased or owned.

The SEC requires that a quarterly report (Form 10-Q), containing financial statements and a management discussion and analysis, be submitted within either 40 or 45 days following the end of the quarter, depending on the market value of the common stock (see Exhibit 2-9). (The Form 10-Q is not required for the fourth quarter of the fiscal year.) Most companies also issue a quarterly report to stockholders. The Form 10-Q and quarterly reports are unaudited.

Exhibit 2-10 GENERAL SUMMARY OF FORM 10-K

Part I

Item 1. Business.
Item 1A. Risk Factors.
Item 1B. Unresolved Staff Comments.
Item 2. Properties.
Item 3. Legal Proceedings.
Item 4. Submission of Matters to a Vote of Security Holders.

Part II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities.
Item 6. Selected Financial Data.
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.
Item 7A. Qualitative and Quantitative Disclosures About Market Risk.
Item 8. Financial Statements and Supplementary Data.
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.
Item 9A. Controls and Procedures.
Item 9B. Other Information.

Part III

Item 10. Directors, Executive Officers, and Corporate Governance.
Item 11. Executive Compensation.
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholders' Matters.
Item 13. Certain Relationships and Related Transactions, and Director Independence.
Item 14. Principal Accountant Fees and Services.

Part IV

Item 15. Exhibits and Financial Statement Schedules.

Signatures

Exhibit Index

In addition to the Form 10-K and Form 10-Q, a Form 8-K must be submitted to the SEC to report special events. Some events required to be reported are changes in principal stockholders, changes in auditors, acquisitions and divestitures, bankruptcy, and resignation of directors. The Form 8-K is due 15 days following the event.

The Forms 10-K, 10-Q, and 8-K filings are available to the public. Many companies are reluctant to send these reports to nonstockholders. In public companies, these reports can be found at http://www.sec.gov.

Proxy

The **proxy**, the solicitation sent to stockholders for the election of directors and for the approval of other corporation actions, represents the shareholder authorization regarding the casting of that shareholder's vote. The proxy contains notice of the annual meeting, beneficial ownership (name, address, and share ownership data of shareholders holding

more than 5% of outstanding shares), board of directors, standing committees, compensation of directors, compensation of executive officers, employee benefit plans, certain transactions with officers and directors, relationship with independent accountants, and other business.

The proxy rules provided under the 1934 Securities Exchange Act are applicable to all securities registered under Section 12 of the Act. The SEC gains its influence over the annual report through provisions of the Act that cover proxy statements.

The SEC's proxy rules of particular interest to investors involve executive compensation disclosure, performance graph, and retirement plans for executive officers. These rules are designed to improve shareholders' understanding of the compensation paid to senior executives and directors, the criteria used in reaching compensation decisions, and the relationship between compensation and corporate performance.

Among other matters, the executive compensation rules call for four highly formatted disclosure tables and the disclosure of the compensation committee's basis for compensation decisions.

The four tables disclosing executive compensation are:

- A summary executive compensation table covering compensation for the company's chief executive officer and its four other most highly compensated executives for the last three years.
- Two tables detailing options and stock appreciation rights.
- A long-term incentive plan award table.

The performance graph is a line graph comparing the cumulative total shareholder return with performance indicators of the overall stock market and either the published industry index or the registrant-determined peer comparison. This performance graph must be presented for a five-year period.

The pension plan table for executive officers discloses the estimated annual benefits payable upon retirement for any defined benefit or actuarial plan under which benefits are determined primarily by final compensation (or average final compensation) and years of service. Immediately following the table, additional disclosure is required. This disclosure includes items such as the relationship of the covered compensation to the compensation reported in the summary compensation table and the estimated credited years of service for each of the named executive officers.

For public companies, the proxy can be found at http://www.sec.gov.

Summary Annual Report

A reporting option available to public companies is to issue a **summary annual report**. A summary annual report, a condensed report, omits much of the financial information typically included in an annual report. A typical full annual report has more financial pages than nonfinancial pages. A summary annual report generally has more nonfinancial pages.[3] When a company issues a summary annual report, the proxy materials it sends to shareholders must include a set of fully audited statements and other required financial disclosures.

A summary annual report is *not* adequate for reasonable analysis. For companies that issue a summary annual report, request a copy of their proxy and the Form 10-K. Even for companies that issue a full annual report, it is also good to obtain a copy of the proxy materials and the Form 10-K. Some companies issue a joint annual report and Form 10-K, while other companies issue a joint annual report and proxy. A few companies issue a joint annual report, Form 10-K, and proxy. These joint reports are usually labeled as the annual report.

The Efficient Market Hypothesis

The **efficient market hypothesis (EMH)** relates to the ability of capital markets to generate prices for securities that reflect worth. The EMH implies that publicly available information is fully reflected in share prices. The market will not be efficient if the market does not have access to relevant information or if fraudulent information is provided.

There seems to be little doubt that the FASB and the SEC assess the impact of their actions on security prices. The SEC has been particularly sensitive to insider trading because abnormal returns could be achieved by the use of insider information.

If the market is efficient, investors may be harmed when firms do not follow a full disclosure policy. In an efficient market, the method of disclosure is not as important as whether the item is disclosed. It should not matter whether an item is disclosed in the body of the financial statements or in the notes. It is the disclosure rather than how to disclose that is the substantive issue.

Usually, there is a cost to disclose. An attempt should be made to determine the value of additional disclosure in relation to the additional cost. Disclosure should be made when the perceived benefits exceed the additional cost to provide the disclosure.

It is generally recognized that the market is more efficient when dealing with large firms trading on large organized stock markets than it is for small firms that are not trading on large organized stock markets.

Although the research evidence regarding the EMH is conflicting, this hypothesis has taken on an important role in financial reporting in the United States.

Ethics

"Ethics and morals are synonymous. While *ethics* is derived from Greek, *morals* is derived from Latin. They are interchangeable terms referring to ideals of character and conduct. These ideals, in the form of codes of conduct, furnish criteria for distinguishing between right and wrong."[4] Ethics has been a subject of investigation for hundreds of years. Individuals in financial positions must be able to recognize ethical issues and resolve them in an appropriate manner.

Ethics affect all individuals—from the financial clerk to the high-level financial executive. Individuals make daily decisions based on their individual values. Some companies and professional organizations have formulated a code of ethics as a statement of aspirations and a standard of integrity beyond that required by law (which can be viewed as the minimum standard of ethics).

Ten essential values can be considered central to relations between people.[5]

1. Caring
2. Honesty
3. Accountability
4. Promise keeping
5. Pursuit of excellence
6. Loyalty
7. Fairness
8. Integrity
9. Respect for others
10. Responsible citizenship

Ethics can be a particular problem with financial reports. Accepted accounting principles leave ample room for arriving at different results in the short run. Highly subjective estimates can substantially influence earnings. What provision should be made for warranty costs? What should be the loan loss reserve? What should be the allowance for doubtful accounts?

The American Accounting Association initiated a project in 1988 on professionalism and ethics. One of the goals of this project was to provide students with a framework for evaluating their courses of action when encountering ethical dilemmas. The American Accounting Association developed a decision model for focusing on ethical issues.[6]

1. Determine the facts—what, who, where, when, how.
2. Define the ethical issues (includes identifying the identifiable parties affected by the decision made or action taken).

3. Identify major principles, rules, and values.
4. Specify the alternatives.
5. Compare norms, principles, and values with alternatives to see if a clear decision can be reached.
6. Assess the consequences.
7. Make your decision.

Example 1: Questionable Ethics in Savings and Loans

In connection with the savings and loan (S&L) scandal, it was revealed that several auditors of thrift institutions borrowed substantial amounts from the S&L that their firm was auditing. It was charged that some of the loans involved special consideration.[7] In one case, dozens of partners of a major accounting firm borrowed money for commercial real estate loans, and some of the partners defaulted on their loans when the real estate market collapsed.[8] It was not clear whether these particular loans violated professional ethics standards. The AICPA subsequently changed its ethics standards to ban all such loans.

In another case, an accounting firm paid $1.5 million to settle charges by the California State Board of Accountancy that the accounting firm was grossly negligent in its audit of Lincoln Savings & Loan. The accounting board charged that the firm had agreed to the improper recognition of approximately $62 million in profits.[9]

Example 2: Questionable Ethics in the Motion Picture Industry

Hollywood's accounting practices have often been labeled "mysterious."[10] A case in point is Art Buchwald's lawsuit against Paramount Pictures for breach of contract regarding the film *Coming to America*. Paramount took an option on Buchwald's story "King for a Day" in 1983 and promised Buchwald 1.5% of the net profits of the film. Buchwald's attorney, Pierce O'Donnell, accused Paramount Studios of "fatal subtraction" in determining the amount of profit. Although the film grossed $350 million worldwide, Paramount claimed an $18 million net loss. As a result of the studio's accounting practices, Buchwald was to get 1.5% of nothing.[11] Buchwald was eventually awarded $150,000 in a 1992 court decision.[12]

Many Hollywood celebrities, in addition to Art Buchwald, have sued over Hollywood-style accounting. These include Winston Groom over the movie rights to *Forrest Gump,* Jane Fonda over a larger share of profits relating to *On Golden Pond*, and James Garner over his share of profits from *The Rockford Files* (a television program). Some of the best creative work in Hollywood is in accounting.

SEC Requirements—Code of Ethics

In January 2003, the SEC voted to require disclosure in a company's annual report whether it has a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. The rules will define a code of ethics as written standards that are reasonably necessary to deter wrongdoing and to promote:

1. Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
2. Full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the Commission and in other public communications made by the company;
3. Compliance with applicable governmental laws, rules, and regulations;
4. The prompt internal reporting of code violations to an appropriate person or persons identified in the code; and
5. Accountability for adherence to the code.[13]

The SEC requires that a copy of the company's code of ethics be made available by filing an exhibit with its annual report (10-K), or by providing it on the company's Web site.

The SEC requirements were an outcome of the Sarbanes-Oxley Act. Exhibit 2-11 presents NIKE's code of ethics.

Exhibit 2-11 THE NIKE CODE OF ETHICS*

Defining the NIKE Playing Field and the Rules of the Game

Do the Right Thing

A Message from Phil

At NIKE, we are on the offense, always. We play hard, we play to win, but we play by the rules of the game.

This Code of Ethics is vitally important. It contains the rules of the game for NIKE, the rules we live by and what we stand for. Please read it, and if you've read it before, read it again.

Then take some time to think about what it says and make a commitment to play by it. Defining the NIKE playing field ensures no matter how dynamic and challenging NIKE may be, our actions and decisions fit with our shared values.

Thank you for your commitment.

Philip H. Knight

Note: Philip H. Knight is the Chairman of the Board of Directors of NIKE.

The NIKE Code of Ethics is backed by a twenty-one page "Defining the NIKE Playing Field and the Rules of the Game."

The NIKE Code of Ethics can be found at http://www.nikebiz.com. Click on "Investors," click on "Corporate Governance," click on "Code of Ethics," and click on "Code of Business Conduct & Ethics."

*Our principal business activity is the design, development and worldwide marketing of high-quality footwear, apparel, equipment, and accessory products." 10-K

Harmonization of International Accounting Standards

The impetus for changes in accounting practice has come from the needs of the business community and governments. With the expansion of international business and global capital markets, the business community and governments have shown an increased interest in the harmonization of international accounting standards.

Suggested problems caused by the lack of harmonization of international accounting standards include the following:

1. A need for employment of key personnel in multinational companies to bridge the "gap" in accounting requirements between countries.
2. Difficulties in reconciling local standards for access to other capital markets.
3. Difficulties in accessing capital markets for companies from less-developed countries.[14]
4. Negative effect on the international trade of accounting practice and services.[15]

Domestic accounting standards have developed to meet the needs of domestic environments. A few of the factors that influence accounting standards locally are as follows:

1. A litigious environment in the United States that has led to a demand for more detailed standards in many cases.
2. High rates of inflation in some countries that have resulted in periodic revaluation of fixed assets and other price-level adjustments or disclosures.
3. More emphasis on financial reporting/income tax conformity in certain countries (for example, Japan and Germany) that no doubt greatly influences domestic financial reporting.
4. Reliance on open markets as the principal means of intermediating capital flows that has increased the demand for information to be included in financial reports in the United States and some other developed countries.[16]

The following have been observed to have an impact on a country's financial accounting operation:

1. Who the investors and creditors—the information users—are (individuals, banks, the government).
2. How many investors and creditors there are.
3. How close the relationship is between businesses and the investor/creditor group.
4. How developed the stock exchanges and bond markets are.
5. The extent of use of international financial markets.[17]

With this backdrop of fragmentation, it has been difficult in the short run, if not impossible, to bring all national standards into agreement with a meaningful body of international standards. But many see benefits to harmonization of international accounting standards and feel that accounting must move in that direction. In the short run, ways exist to cope with incomparable standards. One possible interim solution involves dual standards. International companies would prepare two sets of financial statements. One would be prepared under domestic GAAP, while the other would be prepared under international GAAP. This would likely put pressure on domestic GAAP to move toward international GAAP.

In the United States, a conflict exists between the SEC and the securities exchanges, such as the New York Stock Exchange (NYSE). In general, the SEC has required foreign registrants to conform to U.S. GAAP, either directly or by reconciliation. This approach achieved a degree of comparability in the U.S. capital market, but it did not achieve comparability for investors who want to invest in several national capital markets. This approach poses a problem for U.S. securities exchanges, because the U.S. standards are perceived to be the most stringent. This puts exchanges such as the NYSE at a competitive disadvantage with foreign exchanges that have lower standards. The development of international standards would alleviate this problem.

The United Nations (UN) has shown a substantial interest in the harmonization of international accounting standards. The UN appointed a group to study harmonization of international accounting standards in 1973. This has evolved into an ad hoc working group. Members of the working group represent governments and not the private sector. The working group does not issue standards but rather facilitates their development. The UN's concern is with how multinational corporations affect the developing countries.[18]

Many other organizations, in addition to the IASB and the UN, have played a role in the harmonization of international accounting standards. Some of these organizations include the Financial Accounting Standards Board (FASB), the European Economic Community (EEC), the Organization for Economic Cooperation and Development (OECD), and the International Federation of Accountants (IFAC).

In 1973, nine countries, including the United States, formed the International Accounting Standards Committee (IASC). The IASC included approximately 100 member nations and well over 100 professional accounting bodies. The IASC was the only private-sector body involved in setting international accounting standards. International Accounting Standards (IAS) were issued by the IASC from 1973 to 2000.

The IASC's objectives included the following:

1. Developing international accounting standards and disclosure to meet the needs of international capital markets and the international business community.
2. Developing accounting standards to meet the needs of developing and newly industrialized countries.
3. Working toward increased comparability between national and international accounting standards.[19]

The International Accounting Standards Board (IASB) was established in January 2001 to replace the IASC. The IASB arose from a review of the structure of the IASC. The new structure has characteristics similar to that of the FASB. The IASB basically continues the objectives of the IASC.

The IASB does not have authority to enforce its standards, but these standards have been adopted in whole or in part by approximately 100 countries. Some see the lack of enforcement authority as a positive factor because it enables the passing of standards that would have not had the necessary votes if they could be enforced. This allows standards to be more ideal than they would otherwise be if they were enforceable. The IASB issues International Financial Reporting Standards (IFRSs). The term IFRSs now refers to the entire body of international standards.

The IASB follows a due-process procedure similar to that of the FASB. This includes Exposure Drafts and a comment period. All proposed standards and guidelines are exposed for comment for about six months.

The Financial Accounting Standards Board and the International Accounting Standards Board met jointly in Norwalk, Connecticut, on September 18, 2002. They acknowledge their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. (This is known as the Norwalk Agreement.)

Since the Norwalk Agreement, the FASB and IASB have made significant progress. In joint meetings in April and October 2005, the FASB and the IASB reaffirmed their commitment to the convergence of U.S. GAAP and International Financial Reporting Standards. In a joint meeting February 27, 2006, they agreed on a road map for convergence between U.S. GAAP and IFRS during 2006–2008. Some topics identified for short-term convergence include the following:[20]

To Be Examined by the FASB	To Be Examined by the IASB
1. Fair value option	1. Borrowing costs
2. Impairment	2. Impairment
3. Income tax	3. Income tax
4. Investment properties	4. Government grants
5. Research and development	5. Joint ventures
6. Subsequent events	6. Segment reporting

The FASB and IASB also agreed on major joint topics. Those topics are as follows:[21]

1. Business combinations
2. Consolidations
3. Fair value measurement guidance
4. Liabilities and equity distinctions
5. Performance reporting
6. Postretirement benefits
7. Revenue recognition
8. Derecognition
9. Financial instruments
10. Intangible assets
11. Leases

The major joint topic performance reporting—financial statement presentation—was updated July 2007. This project includes the presentation and display on the face of the financial statements that constitute a complete set of financial statements. This project would drastically alter and change the presentation and display on the face of the financial statements as now presented by U.S. GAAP and IFRSs.

Completion of these major projects will take several years. They will substantially alter IFRSs and likely eliminate U.S. GAAP.

In 2007, the Securities and Exchange Commission announced that it would accept financial statements from foreign private issuers without reconciliation to U.S. GAAP if they are prepared using IFRSs as issued by the International Accounting Standards Board. It is also considering allowing U.S. companies to use U.S. GAAP or IFRSs. Also in 2007, President Bush signed an agreement between the United States and the European Union that sets the stage to allow many public companies to drop U.S. GAAP in favor of more flexible international rules. Some of these international accounting issues will be covered in subsequent chapters.

Consolidated Statements

Financial statements of legally separate entities may be issued to show financial position, income, and cash flow as they would appear if the companies were a single entity (consolidated). Such statements reflect an economic, rather than a legal, concept of the entity. For consolidated statements, all transactions between the entities being consolidated—intercompany transactions—must be eliminated.

When a subsidiary is less than 100% owned and its statements are consolidated, minority shareholders must be recognized in the consolidated financial statements by showing the minority interest in net assets on the balance sheet and the minority share of earnings on the income statement. Minority-related accounts are discussed in detail in Chapter 3.

Consolidated statements are financial statements that a parent company produces when its financial statements and those of a subsidiary are added together. This portrays the resulting financial statements as a single company. The parent company concept emphasizes the interests of the controlling shareholders (the parent's shareholders). A subsidiary is a company controlled by another company. An unconsolidated subsidiary is accounted for as an investment on the parent's balance sheet.

There are two reporting approaches to presenting consolidated statements. In one approach, the subsidiary's accounts are shown separately from the parent's. This format is logical when the parent has a subsidiary in a different line of business. Ford Motor Company consolidates presenting the automotive and financial services category separately.

Most companies consolidate the parents and subsidiary accounts summed. The Dow Chemical Company consolidates summing the accounts.

The parent company can have legal control with ownership of a majority of the subsidiary's outstanding voting shares. The parent company can have effective control when a majority of the subsidiary board of directors can be elected by means other than by having legal control.

A company could have ownership of the majority voting shares and not have control. Such a situation would be a subsidiary that has filed for bankruptcy protection. In the bankruptcy situation, the judge in the bankruptcy court has assumed control.

Control can be gained by means other than obtaining majority stock ownership. The FASB recognizes a risks, rewards, decision-making ability and the primary beneficiary. Thus, consolidation would be required when a firm bears the majority (over 50%) of the risks and/or rewards of ownership. Examples of consolidating because of risks, rewards, and decision-making ability would be a contractual situation to accept substantial production or a loan situation which grants substantial control.

The consolidation of financial statements has been a practice in the United States for years; however, this has not been the case for many other nations. Some countries do not consolidate. Other countries use consolidation with different rules. Countries such as Canada, France, Germany, Italy, Japan, and the United Kingdom do consolidate, but each has different consolidation standards.

The IASC passed a standard that requires that all controlled subsidiaries be consolidated. Although IASC standards cannot be enforced, this standard will likely increase the acceptance of consolidation.

Accounting for Business Combinations

The combination of business entities by merger or acquisition is very frequent. There are many possible reasons for this external business expansion, including achieving economies of scale and savings of time in entering a new market. The combination must be accounted for using the **purchase method**.

The purchase method views the business combination as the acquisition of one entity by another. The firm doing the acquiring records the identifiable assets and liabilities at fair value at the date of acquisition. The difference between the fair value of the identifiable assets and liabilities and the amount paid is recorded as goodwill (an asset).

With a purchase, the acquiring firm picks up the income of the acquired firm from the date of acquisition. Retained earnings of the acquired firm do not continue.

Summary

This chapter includes an introduction to the basic financial statements. Later chapters will cover these statements in detail.

An understanding of the sequence of accounting procedures completed during each accounting period, called the accounting cycle, will help in understanding the end result—financial statements.

This chapter describes the forms of business entities, which are sole proprietorship, partnership, and corporation.

Management is responsible for financial statements. These statements are examined by auditors who express an opinion regarding the statements' conformity to GAAP in the auditor's report. The auditor's report often points out key factors that can affect financial statement analysis. The SEC has begun a program to integrate the Form 10-K requirements with those of the annual report.

A reporting option available to public companies, a summary annual report (a condensed annual report), omits much of the financial information included in a typical annual report.

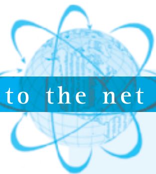
The EMH relates to the ability of capital markets to generate prices for securities that reflect worth. The market will not be efficient if the market does not have access to relevant information or if fraudulent information is provided.

Individuals in financial positions must be able to recognize ethical issues and resolve them appropriately.

With the expansion of international business and global capital markets, the business community and governments have shown an increased interest in the harmonization of international accounting standards.

Financial statements of legally separate entities may be issued to show financial position, income, and cash flow as they would appear if the companies were a single entity (consolidated).

The combination of business entities by merger or acquisition is very frequent. An understanding of how a business combination can impact the basic statements is important to the analyst.



to the net

1. Go to the Carol and Lawrence Zicklin Center for Business Ethics Research Web site: http://www.zicklincenter.org. Copy the mission statement. Click on "Links." Click on "Publications & Journals." Choose a journal from the list provided. Go to a library and review an article in the journal selected. Summarize the information provided by the article.

2. Go to the Carol and Lawrence Zicklin Center for Business Ethics Research Web site: http://www.zicklincenter.org. Click on "Links." Under "Codes of Conduct, Online Resources," select a company. Summarize that company's code of conduct.

3. Go to the Carol and Lawrence Zicklin Center for Business Ethics Research Web site: http://www.zicklincenter.org. Click on "Links." Under "Corporate Scandals," select a company. Write a summary of the corporate scandal.

4. The following Web sites provide for an in-depth review of the emergence of IFRSs:

   a. Go to the International Accounting Standards Board (IASB) Web site: http://www.iasb.org. Click on "About Us." Comment on the IASB structure.

   b. Go to the FASB Web site: http://www.fasb.org. Click on "International." Click on "Convergence with the IASB." Write a summary of the convergence with the IASB.

   c. Go to the Web site http://www.iasplus.com/country/useias.htm. Comment on the adoption status of IFRSs by country. (IFRSs not permitted, IFRSs permitted, IFRSs required for some, IFRSs required for all, use of IFRSs by unlisted companies.)

   d. Go to the Web site http://www.iasplus.com/standard/standard.htm. Select a recent IFRS and comment on the contents of the summary.

   e. Go to the Web site http://www.iasplus.com/fs/fs.htm. What do the IFRS Model Financial Statements illustrate?

5. Go to the COSO Web site: http://www.coso.org. What is COSO? List the five major professional associations that sponsored COSO.

6. Consolidated Statement Presentation

   Go to the SEC Web site: http://www.sec.gov. Under "Filings & Forms (EDGAR)," click on "Search for Company Filings." Click on "Companies & Other Filers."

   a. Under Company Name, enter "Ford Motor Co" (or under Ticker Symbol, enter "F"). Select the 2006 10-K. Review the Sector Statement of Income found a little over half-way through the document. Describe in some detail the consolidation presentation. (Refer to comments in this chapter.)
   b. Type in "Dow Chemical Co" (or under Ticker Symbol, enter "DOW"). Select the 2006 10-K. Review the consolidated statements of income. Describe in some detail the reconsolidation presentation. (Refer to comments in this chapter.)

7. Proxy

   Go to the SEC Web site: http://www.sec.gov. Under "Filings & Forms (EDGAR)," click on "Search for Company Filings." Click on "Companies & Other Filers." Under Company Name, enter "Gorman-Rupp Company" (or under Ticker Symbol, enter "GRC"). Select the 2006 proxy. Go to Executive Compensation within the proxy. Describe the executive compensation.

8. Audit Report and Auditor's Report on the Firm's Internal Controls

   Go to the SEC Web site: http://www.sec.gov. Under "Filings & Forms (EDGAR)," click on "Search for Company Filings." Click on "Companies & Other Filers." Under Company Name, enter "Bemis Company" (or under Ticker Symbol, enter "BMS"). Select the 2006 10-K. Go to Report of Independent Registered Public Accounting Firm. Compare this report with Exhibit 2-5 (Audit Opinion) and Exhibit 2-6 (Auditor's Report on the Firm's Internal Controls). What is the basic difference in presentation?

Questions

Q 2-1. Name the type of opinion indicated by each of the following situations:
a. There is a material uncertainty.
b. There was a change in accounting principle.
c. There is no material scope limitation or material departure from GAAP.
d. The financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with GAAP.
e. Except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity, in conformity with GAAP.

Q 2-2. What are the roles of management and the auditor in the preparation and integrity of the financial statements?

Q 2-3. What is the purpose of the SEC's integrated disclosure system for financial reporting?

Q 2-4. Why do some unqualified opinions have explanatory paragraphs?

Q 2-5. Describe an auditor's review of financial statements.

Q 2-6. Will the accountant express an opinion on reviewed financial statements? Describe the accountant's report for reviewed financial statements.

Q 2-7. What type of opinion is expressed on a compilation?

Q 2-8. Are all financial statements presented with some kind of an accountant's report? Explain.

Q 2-9. What are the three principal financial statements of a corporation? Briefly describe the purpose of each statement.

Q 2-10. Why are notes to statements necessary?

Q 2-11. What are contingent liabilities? Are lawsuits against the firm contingent liabilities?

Q 2-12. Which of the following events, occurring subsequent to the balance sheet date, would require a note?
a. Major fire in one of the firm's plants
b. Increase in competitor's advertising
c. Purchase of another company
d. Introduction of new management techniques
e. Death of the corporate treasurer

Q 2-13. Describe a proxy statement.

Q 2-14. Briefly describe a summary annual report.

Q 2-15. If a company issues a summary annual report, where can the more extensive financial information be found?

Q 2-16. Comment on the typical number of financial pages in a summary annual report as compared to a full annual report.

Q 2-17. What are the major sections of a statement of cash flows?

Q 2-18. Which two principal financial statements explain the difference between two balance sheet dates? Describe how these financial statements explain the difference between two balance sheet dates.

Q 2-19. What are the three major categories on a balance sheet?

Q 2-20. Can cash dividends be paid from retained earnings? Comment.

Q 2-21. Why review notes to financial statements?

Q 2-22. Where do we find a description of a firm's accounting policies?

Q 2-23. Describe the relationship between the terms *ethics* and *morals*.

Q 2-24. What is the relationship between ethics and law?

Q 2-25. Identify the basic accounting equation.

Q 2-26. What is the relationship between the accounting equation and the double-entry system of recording transactions?

Q 2-27. Define the following:
a. Permanent accounts
b. Temporary accounts

Q 2-28. A typical accrual recognition for salaries is as follows:

Salaries Expense	$1,000 (increase)
Salaries Payable	1,000 (increase)

Explain how the matching concept applies in this situation.

Q 2-29. Why are adjusting entries necessary?

Q 2-30. Why aren't all transactions recorded in the general journal?

Q 2-31. The NYSE has trouble competing with many foreign exchanges in the listing of foreign stocks. Discuss.

Q 2-32. Identify the usual forms of a business entity and describe the ownership characteristic of each.

Q 2-33. Why would the use of insider information be of concern if the market is efficient?

Q 2-34. Considering the EMH, it is best if financial disclosure is made in the body of the financial statements. Comment.

Q 2-35. Considering the EMH, how could abnormal returns be achieved?

Q 2-36. Describe the purchase method of accounting for a business combination.

Q 2-37. Consolidated statements may be issued to show financial position as it would appear if two or more companies were one entity. What is the objective of these statements?

Q 2-38. What is the basic guideline for consolidation?

Q 2-39. Where must a company's code of ethics be made available?

Q 2-40. Describe the Treadway Commission.

Q 2-41. Why is the COSO report on internal control systems important under requirements of the Sarbanes-Oxley Act?

Q 2-42. Under Sarbanes-Oxley, the auditing firm will include which two reports with the audited statements? (*Note:* These two reports can be combined into one report.)

Q 2-43. Under Sarbanes-Oxley, management must include what report with the audited statements?

Q 2-44. Private companies are not under Sarbanes-Oxley. Why do some private companies follow the law?

Q 2-45. Indicate the two approaches to presenting consolidated statements.

Q 2-46. Describe how a company could be required to consolidate another company in which it has no or minor voting stock.

Q 2-47. Consolidation rules are similar between countries. Comment.

Q 2-48. Describe the filing deadline for Form 10-K.

Q 2-49. Describe the Norwalk Agreement.

Q 2-50. Comment on the impact on U.S. GAAP if the short-term convergence and the major topics are completed.

Problems

P 2-1. Mike Szabo Company engaged in the following transactions during the month of December:

December 2 Made credit sales of $4,000 (accepted accounts receivable).
6 Made cash sales of $2,500.
10 Paid office salaries of $500.
14 Sold land that originally cost $2,200 for $3,000 cash.
17 Paid $6,000 for equipment.
21 Billed clients $900 for services (accepted accounts receivable).
24 Collected $1,200 on an account receivable.
28 Paid an account payable of $700.

Required Record the transactions, using T-accounts.

P 2-2. Darlene Cook Company engaged in the following transactions during the month of July:

July 1 Acquired land for $10,000. The company paid cash.

8 Billed customers for $3,000. This represents an increase in revenue. The customer has been billed and will pay at a later date. An asset, accounts receivable, has been created.

12 Incurred a repair expense for repairs of $600. Darlene Cook Company agreed to pay in 60 days. This transaction involves an increase in accounts payable and repair expense.

15 Received a check for $500 from a customer who was previously billed. This is a reduction in accounts receivable.

20 Paid $300 for supplies. This was previously established as a liability, account payable.

24 Paid wages in the amount of $400. This was for work performed during July.

Required Record the transactions, using T-accounts.

P 2-3. Gaffney Company had these adjusting entry situations at the end of December.

1. On July 1, Gaffney Company paid $1,200 for a one-year insurance policy. The policy was for the period July 1 through June 30. The transaction was recorded as prepaid insurance and a reduction in cash.
2. On September 10, Gaffney Company purchased $500 of supplies for cash. The purchase was recorded as supplies. On December 31, it was determined that various supplies had been consumed in operations and that supplies costing $200 remained on hand.
3. Gaffney Company received $1,000 on December 1 for services to be performed in the following year. This was recorded on December 1 as an increase in cash and as revenue. As of December 31, this needs to be recognized as Unearned Revenue, a liability account.
4. As of December 31, interest charges of $200 have been incurred because of borrowed funds. Payment will not be made until February. A liability for the interest needs to be recognized as does the interest expense.
5. As of December 31, a $500 liability for salaries needs to be recognized.
6. As of December 31, Gaffney Company had provided services in the amount of $400 for Jones Company. An asset, Accounts Receivable, needs to be recognized along with the revenue.

Required Record the adjusting entries at December 31, using T-accounts.

P 2-4. DeCort Company had these adjusting entry situations at the end of December:

1. On May 1, DeCort Company paid $960 for a two-year insurance policy. The policy was for the period May 1 through April 30 (2 years). This is the first year of the policy. The transaction was recorded as insurance expense.
2. On December 1, DeCort Company purchased $400 of supplies for cash. The purchase was recorded as an asset, supplies. On December 31, it was determined that various supplies had been consumed in operations and that supplies costing $300 remained on hand.
3. DeCort Company holds a note receivable for $4,000. This note is interest-bearing. The interest will be received when the note matures. The note is a one-year note receivable made on June 30, bearing 5% simple interest.
4. DeCort Company owes salaries in the amount of $800 at the end of December.
5. As of December 31, DeCort Company had received $600 for services to be performed. These services had not been performed as of December 31. A liability, Unearned Revenue, needs to be recognized, and revenue needs to be reduced.
6. On December 20, DeCort Company received a $400 bill for advertising in December. The liability account, Accounts Payable, needs to be recognized along with the related expense.

Required Record the adjusting entries at December 31, using T-accounts.

P 2-5.

Required Answer the following multiple-choice questions:

a. The balance sheet equation can be defined as which of the following?
   1. Assets + Stockholders' Equity = Liabilities
   2. Assets + Liabilities = Stockholders' Equity
   3. Assets = Liabilities – Stockholders' Equity
   4. Assets – Liabilities = Stockholders' Equity
   5. None of the above

b. If assets are $40,000 and stockholders' equity is $10,000, how much are liabilities?
   1. $30,000
   2. $50,000
   3. $20,000
   4. $60,000
   5. $10,000
c. If assets are $100,000 and liabilities are $40,000, how much is stockholders' equity?
   1. $40,000
   2. $50,000
   3. $60,000
   4. $30,000
   5. $140,000
d. Which is a permanent account?
   1. Revenue
   2. Advertising Expense
   3. Accounts Receivable
   4. Dividends
   5. Insurance Expense
e. Which is a temporary account?
   1. Cash
   2. Accounts Receivable
   3. Insurance Expense
   4. Accounts Payable
   5. Notes Payable
f. In terms of debits and credits, which accounts have the same normal balances?
   1. Dividends, retained earnings, liabilities
   2. Capital stock, liabilities, expenses
   3. Revenues, capital stock, expenses
   4. Expenses, assets, dividends
   5. Dividends, assets, liabilities

P 2-6.

Required Answer the following multiple-choice questions:

a. Audit opinions cannot be classified as which of the following?
   1. All-purpose
   2. Disclaimer of opinion
   3. Adverse opinion
   4. Qualified opinion
   5. Unqualified opinion
b. From the point of view of analysis, which classification of an audit opinion indicates that the financial statements carry the highest degree of reliability?
   1. Unqualified opinion
   2. All-purpose
   3. Disclaimer of opinion
   4. Qualified opinion
   5. Adverse opinion
c. Which one of the following statements is false?
   1. The reliance that can be placed on financial statements that have been reviewed is substantially less than for those that have been audited.
   2. An accountant's report described as a compilation presents only financial information as provided by management.
   3. A disclaimer of opinion indicates that you should not look to the auditor's report as an indication of the reliability of the statements.
   4. A review has substantially less scope than an examination in accordance with generally accepted auditing standards.
   5. The typical unqualified opinion has one paragraph.

d. If an accountant performs a compilation and becomes aware of deficiencies in the statements, the accountant's report characterizes the deficiencies by all but one of the following:
   1. Omission of substantially all disclosures
   2. Omission of statement of cash flows
   3. Accounting principles not generally accepted
   4. All of the above
   5. None of the above
e. In addition to the company's principal financial statements, the Form 10-K and shareholder annual reports must include all but one of the following:
   1. Information on the market for holders of common stock and related securities, including high and low sales price, frequency and amount of dividends, and number of shares
   2. Five-year summary of selected financial data
   3. Management's discussion and analysis of financial condition and results of operations
   4. Two years of audited balance sheets, three years of audited statements of income, and two years of statements of cash flows
   5. Disclosure of the domestic and foreign components of pretax income
f. Which of these is *not* a suggested problem caused by lack of harmonization of international accounting standards?
   1. Positive effect on the international trade of accounting practice and services
   2. A need for employment of key personnel in multinational companies to bridge the "gap" in accounting requirements between countries
   3. Difficulties in reconciling local standards for access to other capital markets
   4. Difficulties in accessing capital markets for companies from less-developed countries
   5. Negative effect on the international trade of accounting practice and services
g. Which of these organizations has *not* played a role in the harmonization of international accounting standards?
   1. United Nations
   2. Internal Revenue Service
   3. International Accounting Standards Board
   4. Financial Accounting Standards Board
   5. European Economic Community
h. The Form 10-K is submitted to the:
   1. American Institute of Certified Public Accountants
   2. Securities and Exchange Commission
   3. Internal Revenue Service
   4. American Accounting Association
   5. Emerging Issues Task Force

P 2-7.

Required

Answer the following multiple-choice questions:

a. Which party has the primary responsibility for the financial statements?
   1. Bookkeeper
   2. Auditor
   3. Management
   4. Cost accountant
   5. None of the above
b. Which of the following is a type of audit opinion that a firm would usually prefer?
   1. Unqualified opinion
   2. Qualified opinion
   3. Adverse opinion
   4. Clear opinion
   5. None of the above
c. Which of the following statements is true?
   1. You are likely to regard an adverse opinion as an immaterial issue as to the reliability of the financial statements.
   2. A disclaimer of opinion indicates that you should look to the auditor's report as an indication of the reliability of the statements.

3. A review consists principally of inquiries made to company personal and analytical procedures applied to financial data.
4. When the outside accountant presents only financial information as provided by management, he or she is said to have reviewed the financial statements.
5. None of the above

d. This item need *not* be provided with a complete set of financial statements:
1. A 20-year summary of operations
2. Note disclosure of such items as accounting policies
3. Balance sheet
4. Income statement
5. Statement of cash flows

e. Which of the following statements is true?
1. Financial statements of legally separate entities may be issued to show financial position, income, and cash flow as they would appear if the companies were a single entity (consolidated).
2. Consolidated statements reflect a legal, rather than an economic, concept of the entity.
3. The financial statements of the parent and the subsidiary are consolidated for all majority-owned subsidiaries.
4. Consolidated statements are rare in the United States.
5. The acceptance of consolidation has been decreasing.

f. Domestic accounting standards developed to meet the needs of domestic environments. Which of these factors did *not* influence accounting standards locally?
1. A litigious environment in the United States that led to a demand for more detailed standards in many cases
2. High rates of inflation in some countries that resulted in periodic revaluation of fixed assets and other price-level adjustments or disclosures
3. Income tax conformity in certain countries that no doubt greatly influenced domestic financial reporting
4. Reliance on open markets as the principal means of intermediating capital flows that increased the demand for information to be included in financial reports in the United States
5. The need to have standards different from the U.S. standards

P 2-8. The following are selected accounts of Laura Gibson Company on December 31:

	Permanent (P) or Temporary (T)	**Normal Balance (Dr.) or (Cr.)**
Cash	______	______
Accounts Receivable	______	______
Equipment	______	______
Accounts Payable	______	______
Common Stock	______	______
Sales	______	______
Purchases	______	______
Rent Expense	______	______
Utility Expense	______	______
Selling Expense	______	______

Required In the space provided:
1. Indicate if the account is a permanent (P) or temporary (T) account.
2. Indicate the normal balance in terms of debit (Dr.) or credit (Cr.).

P 2-9. An auditor's report is the formal presentation of all the effort that goes into an audit. Below is a list of the classifications of audit opinions that can be found in an auditor's report as well as a list of phrases describing the opinions.

Classifications of Audit Opinions

a. Unqualified opinion
b. Qualified opinion
c. Adverse opinion
d. Disclaimer of opinion

Phrases

_____ 1. This opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity, in conformity with generally accepted accounting principles.

_____ 2. This type of report is rendered when the auditor has not performed an audit sufficient in scope to form an opinion.

_____ 3. This opinion states that, except for the effects of the matters to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity, in conformity with generally accepted accounting principles.

_____ 4. This opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity, in conformity with generally accepted accounting principles.

Required Place the appropriate letter identifying each type of opinion on the line in front of the statement or phrase describing the type of opinion.

P 2-10. A company prepares financial statements in order to summarize financial information. Below is a list of financial statements and a list of descriptions.

Financial Statements

a. Balance sheet
b. Income statement
c. Statement of cash flows
d. Statement of stockholders' equity

Descriptions

_____ 1. Details the sources and uses of cash during a specified period of time.

_____ 2. Summary of revenues and expenses and gains and losses for a specific period of time.

_____ 3. Shows the financial condition of an accounting entity as of a specific date.

_____ 4. Presents reconciliation of the beginning and ending balances of the stockholders' equity accounts.

Required Match each financial statement with its description.

Case 2-1 THE CEO RETIRES*

Dan Murphy awoke at 5:45 A.M., just like he did every workday morning. No matter that he went to sleep only four hours ago. The Orange Bowl game had gone late into the evening, and the New Year's Day party was so good, no one wanted to leave. At least Dan could awake easily this morning. Some of his guests had lost a little control celebrating the first day of the new year, and Dan was not a person who ever lost control.

The drive to the office was easier than most days. Perhaps there were a great many parties last night. All the better as it gave Dan time to think. The dawn of a new year; his last year. Dan would turn 65 next December, and the company had a mandatory retirement policy. A good idea he thought; to get new blood in the organization. At least that's what he thought on the climb up. From just another college graduate within the corporate staff, all the way to the chief executive officer's suite. It certainly is a magnificent view from the top.

To be CEO of his own company. Well, not really, as it was the stockholders' company, but he had been CEO for the past eight years. Now he, too, must turn the reins over. "Must," now that's the operative word. He knew it was the best thing for the company. Turnover kept middle management aggressive, but he also knew that he wouldn't leave if he had a choice. So Dan resolved to make his last year the company's best year ever.

Prepared by Professor William H. Coyle, Babson College.

*Source: "Ethics in the Accounting Curriculum: Cases & Readings," American Accounting Association.

(continued)

Case 2-1 THE CEO RETIRES (Continued)

It was that thought that kept his attention, yet the focus of consideration and related motivations supporting such a strategy changed as he continued to strategize. At first, Dan thought that it would be a fine way to give something back to a company that had given him so much. His 43 years with the company had given him challenges which filled his life with meaning and satisfaction, provided him with a good living, and made him a man respected and listened to in the business community. But the thought that the company was also forcing him to give all that up made his thoughts turn more inward.

Of course, the company had done many things for him, but what of all the sacrifices he had made? His whole heart and soul were tied to the company. In fact, one could hardly think of Dan Murphy without thinking of the company, in much the same way as prominent corporate leaders and their firms are intrinsically linked. But the company would still be here this time next year, and what of him? Yes, he would leave the company strong, because by leaving it strong, it would strengthen his reputation as a great leader. His legacy would carry and sustain him over the years. But would it? One must also live in a manner consistent with such esteem.

Being the CEO of a major company also has its creature comforts. Dan was accustomed to a certain style of living. How much will that suffer after the salary, bonuses, and stock options are no more?

Arriving at the office by 7:30 A.M., he left a note for his secretary that he was not to be disturbed until 9 A.M. He pulled out the compensation file and examined the incentive clauses in his own contract. The contract was created by the compensation committee of the Board of Directors. All of the committee members were outsiders; that is, not a part of the company's management. This lends the appearance of independence, but most were CEOs of their own companies, and Dan knew that, by and large, CEOs take care of their own. His suspicions were confirmed. If the company's financial results were the best ever this year, then so, too, would be his own personal compensation.

Yet what if there were uncontrollable problems? The general economy appeared fairly stable. However, another oil shock, some more bank failures, or a list of other disasters could turn things into a downward spiral quickly. Economies are easily influenced and consumer and corporate psychology can play a large part in determining outcomes. But even in apparently uncontrollable circumstances, Dan knew he could protect himself and the financial fortunes of his company during the short term, which after all, was the only thing that mattered.

Upon further review of his compensation contract, Dan saw that a large portion of his bonus and stock options was a function of operating income levels, earnings per share, and return on assets. So the trick was to maximize those items. If he did, the company would appear vibrant and poised for future growth at the time of his forced retirement, he reminded himself. Furthermore, his total compensation in the last year of his employment would reach record proportions. Additionally, since his pension is based on the average of his last three years' compensation, Dan will continue to reap the benefits of this year's results for hopefully a long time to come. And who says CEOs don't think long term?

Two remaining issues needed to be addressed. Those were (1) how to ensure a record-breaking year and (2) how to overcome any objections raised in attaining those results. Actually, the former was a relatively simple goal to achieve. Since accounting allows so many alternatives in the way financial events are measured, Dan could just select a package of alternatives, which would maximize the company's earnings and return on assets. Some alternatives may result in changing an accounting method, but since the new auditing standards were issued, his company could still receive an unqualified opinion from his auditors, with only a passing reference to any accounting changes in the auditor's opinion and its effects disclosed in the footnotes. As long as the alternative was allowed by generally accepted accounting principles, and the justification for the change was reasonable, the auditors should not object. If there were objections, Dan could always threaten to change auditors. But still the best avenue to pursue would be a change in accounting estimates, since those changes did not even need to be explicitly disclosed.

So Dan began to mull over what changes in estimates or methods he could employ in order to maximize his firm's financial appearance. In the area of accounting estimates, Dan could

(continued)

Case 2-1 THE CEO RETIRES (Continued)

lower the rate of estimated default on his accounts receivable, thus lowering bad debt expense. The estimated useful lives of his plant and equipment could be extended, thus lowering depreciation expense. In arguing that quality improvements have been implemented in the manufacturing process, the warranty expense on the products sold could also be lowered. In examining pension expense, he noted that the assumed rate of return on pension assets was at a modest 6.5%, so if that rate could be increased, the corresponding pension expense could be reduced.

Other possibilities occurred to Murphy. Perhaps items normally expensed, such as repairs, could be capitalized. Those repairs that could not be capitalized could simply be deferred. The company could also defer short-term expenses for the training of staff. Since research and development costs must now be fully expensed as incurred, a reduction in those expenditures would increase net income. Return on assets would be increased by not acquiring any new fixed assets. Production levels for inventory could be increased, thus spreading fixed costs over a greater number of units and reducing the total average cost per unit. Therefore, gross profit per unit will increase. Inventory levels would be a little bloated, but that should be easily handled by Dan's successor.

The prior examples are subtle changes that could be made. As a last resort, a change in accounting methods could be employed. This would require explicit footnote disclosure and a comment in the auditor's report, but if it came to that, it would still be tolerable. Examples of such changes would be to switch from accelerated to straight-line depreciation or to change from LIFO to FIFO.

How to make changes to the financial results of the company appeared easier than he first thought. Now back to the other potential problem of "getting away with it." At first thought, Dan considered the degree of resistance by the other members of top management. Mike Harrington, Dan's chief financial officer, would have to review any accounting changes that he suggested. Since Dan had brought Mike up the organization with him, Dan didn't foresee any strong resistance from Mike. As for the others, Dan believed he had two things going for him. One was their ambition. Dan knew that they all coveted his job, and a clear successor to Dan had yet to be chosen. Dan would only make a recommendation to the promotion committee of the Board of Directors, but everyone knew his recommendation carried a great deal of weight. Therefore, resistance to any accounting changes by any individual would surely end his or her hope to succeed him as CEO. Secondly, although not as lucrative as Dan's, their bonus package is tied to the exact same accounting numbers. So any actions taken by Dan to increase his compensation will also increase theirs.

Dan was actually beginning to enjoy this situation, even considering it one of his final challenges. Dan realized that any changes he implemented would have the tendency to reverse themselves over time. That would undoubtedly hurt the company's performance down the road, but all of his potential successors were in their mid-to-late 50s, so there would be plenty of time for them to turn things around in the years ahead. Besides, any near-term reversals would merely enhance his reputation as an excellent corporate leader, as problems would arise after his departure.

At that moment, his secretary called to inform him that Mike Harrington wanted to see him. Mike was just the man Dan wanted to see.

What are the ethical issues?

What should Mike do?

Required

a. Determine the facts—what, who, where, when, and how.
b. Define the ethical issues.
c. Identify major principles, rules, and values.
d. Specify the alternatives.
e. Compare norms, principles, and values with alternatives to see if a clear decision can be reached.
f. Assess the consequences.
g. Make your decision.

Case 2-2

THE DANGEROUS MORALITY OF MANAGING EARNINGS*

The Majority of Managers Surveyed Say It's Not Wrong to Manage Earnings

Occasionally, the morals and ethics executives use to manage their businesses are examined and discussed. Unfortunately, the morals that guide the timing of nonoperating events and choices of accounting policies largely have been ignored.

The ethical framework used by managers in reporting short-term earnings probably has received less attention than its operating counterpart because accountants prepare financial disclosures consistent with laws and generally accepted accounting principles (GAAP). Those disclosures are reviewed by objective auditors.

Managers determine the short-term reported earnings of their companies by:

- Managing, providing leadership, and directing the use of resources in operations.
- Selecting the timing of some nonoperating events, such as the sale of excess assets or the placement of gains or losses into a particular reporting period.
- Choosing the accounting methods that are used to measure short-term earnings.

Casual observers of the financial reporting process may assume that time, laws, regulation, and professional standards have restricted accounting practices to those that are moral, ethical, fair, and precise. But most managers and their accountants know otherwise—that managing short-term earnings can be part of a manager's job.

To understand the morals of short-term earnings management, we surveyed general managers and finance, control, and audit managers. The results are frightening.

We found striking disagreements among managers in all groups. Furthermore, the liberal definitions revealed in many responses of what is moral or ethical should raise profound questions about the quality of financial information that is used for decision-making purposes by parties both inside and outside a company. It seems many managers are convinced that if a practice is not explicitly prohibited or is only a slight deviation from rules, it is an ethical practice regardless of who might be affected either by the practice or the information that flows from it. This means that anyone who uses information on short-term earnings is vulnerable to misinterpretation, manipulation, or deliberate deception.

The Morals of Managing Earnings

To find a "revealed" consensus concerning the morality of engaging in earnings-management activities, we prepared a questionnaire describing 13 earnings-management situations we had observed either directly or indirectly. The actions described in the incidents were all legal (although some were in violation of GAAP), but each could be construed as involving short-term earnings management.

A total of 649 managers completed our questionnaire. Table 2-1 classifies respondents by job function. Table 2-2 summarizes the views on the acceptability of various earnings-management practices.

A major finding of the survey was a striking lack of agreement. None of the respondent groups viewed any of the 13 practices unanimously as an ethical or unethical practice. The

Table 2-1 SURVEY RESPONDENTS

Total Sample	
General Managers	119
Finance, Control, & Audit Managers	262
Others or Position Not Known	268
	649

*Source: Reprinted from Management Accounting, August 1990. Copyright by National Association of Accountants, Montvale, NJ.

(continued)

Case 2-2 THE DANGEROUS MORALITY OF MANAGING EARNINGS (Continued)

dispersion of judgments about many of the incidents was great. For example, here is one hypothetical earnings-management practice described in the questionnaire:

> *In September, a general manager realized that his division would need a strong performance in the last quarter of the year in order to reach its budget targets. He decided to implement a sales program offering liberal payment terms to pull some sales that would normally occur next year into the current year. Customers accepting delivery in the fourth quarter would not have to pay the invoice for 120 days.*

Table 2-2 MANAGING SHORT-TERM EARNINGS

Proportion of Managers Who Judge the Practice*

	Ethical	Questionable, or a Minor Infraction	Unethical, or a Serious Infraction
1. Managing short-term earnings by changing or manipulating operating decisions or procedures:			
When the result is to reduce earnings	79%	19%	2%
When the result is to increase earnings	57%	31%	12%
2. Managing short-term earnings by changing or manipulating accounting methods:			
When the change to earnings is small	5%	45%	50%
When the change to earnings is large	3%	21%	76%
3. Managing short-term earnings by deferring discretionary expenditures into the next accounting period:			
To meet an interim quarterly budget target	47%	41%	12%
To meet an annual budget target	41%	35%	24%
4. Increasing short-term earnings to meet a budget target:			
By selling excess assets and realizing a profit	80%	16%	4%
By ordering overtime work at year-end to ship as much as possible	74%	21%	5%
By offering customers special credit terms to accept delivery without obligation to pay until the following year	43%	44%	15%

*Percentages are calculated from *Harvard Business Review* readers' sample.

The survey respondents' judgments of the acceptability of this practice were distributed as follows:

Ethical	279
Questionable	288
Unethical	82
Total	649

Perhaps you are not surprised by these data. The ethical basis of an early shipment/liberal payment program may not be something you have considered, but, with the prevalence of such diverse views, how can any user of a short-term earnings report know the quality of the information?

Although the judgments about all earnings-management practices varied considerably, there are some other generalizations that can be made from the findings summarized in Table 2-2.

- On average, the respondents viewed management of short-term earnings by *accounting* methods as significantly less acceptable than accomplishing the same ends by changing or manipulating *operating decisions or procedures*.
- The direction of the effect on earnings matters. *Increasing* earnings is judged less acceptable than *reducing* earnings.

(continued)

Case 2-2 THE DANGEROUS MORALITY OF MANAGING EARNINGS (Continued)

- Materiality matters. Short-term earnings management is judged less acceptable if the earnings effect is *large* rather than *small*.
- The time period of the effect may affect ethical judgments. Managing short-term earnings at the end of an interim *quarterly* reporting period is viewed as somewhat more acceptable than engaging in the same activity at the end of an *annual* reporting period.
- The method of managing earnings has an effect. Increasing profits by offering *extended credit terms* is seen as less acceptable than accomplishing the same end by *selling excess assets or using overtime* to increase shipments.

Managers Interviewed

Were the survey results simply hypothetical, or did managers recognize they can manage earnings and choose to do so? To find the answers, we talked to a large number of the respondents. What they told us was rarely reassuring.

On accounting manipulations, a profit center controller reported:

> *"Accounting is grey. Very little is absolute . . . You can save your company by doing things with sales and expenses, and, if it's legal, then you are justified in doing it."*

A divisional general manager spoke to us about squeezing reserves to generate additional reported profit:

> *"If we get a call asking for additional profit, and that's not inconceivable, I would look at our reserves. Our reserves tend to be realistic, but we may have a product claim that could range from $50,000 to $500,000. Who knows what the right amount for something like that is? We would review our reserves, and if we felt some were on the high side, we would not be uncomfortable reducing them."*

We also heard about operating manipulations. One corporate group controller noted:

> *"[To boost sales] we have paid overtime and shipped on Saturday, the last day of the fiscal quarter. If we totally left responsibility for the shipping function to the divisions, it could even slip over to 12:30 A.M. Sunday. There are people who would do that and not know it's wrong."*

Managers often recognize that such actions "move" earnings from one period to another. For example, a division controller told us:

> *"Last year we called our customers and asked if they would take early delivery. We generated an extra $300,000 in sales at the last minute. We were scratching for everything. We made our plans, but we cleaned out our backlog and started in the hole this year. We missed our first quarter sales plan. We will catch up by the end of the second quarter."*

And a group vice president said:

> *"I recently was involved in a situation where the manager wanted to delay the production costs for the advertising that would appear in the fall [so that he could meet his quarterly budget]."*

Thus, in practice, it appears that a large majority of managers use at least some methods to manage short-term earnings. Although legal, these methods do not seem to be consistent with a strict ethical framework. While the managers' actions have the desired effect on reported earnings, the managers know there are no real positive economic benefits, and the actions might actually be quite costly in the long run. These actions are at best questionable because they involve deceptions that are not disclosed. Most managers who manage earnings, however, do not believe they are doing anything wrong.

We see two major problems. The most important is the generally high tolerance for operating manipulations. The other is the dispersion in managers' views about which practices are moral and ethical.

(continued)

Case 2-2 THE DANGEROUS MORALITY OF MANAGING EARNINGS (Continued)

The Dangerous Allure

The essence of a moral or ethical approach to management is achieving a balance between individual interests and obligations to those who have a stake in what happens in the corporation (or what happens to a division or group within the corporation). These stakeholders include not only people who work in the firm, but customers, suppliers, creditors, shareholders, and investors as well.

Managers who take unproductive actions to boost short-term earnings may be acting totally within the laws and rules. Also they may be acting in the best interest of the corporation. But, if they fail to consider the adverse effects of their actions on other stakeholders, we may conclude that they are acting unethically.

The managers we interviewed explained that they rated accounting manipulations harshly because in such cases the "truth" has somehow been denied or misstated. The recipients of the earnings reports do not know what earnings would have been if no manipulation had taken place. Even if the accounting methods used are consistent with GAAP, they reason, the actions are not ethical because the interests of major stakeholder groups—including the recipients of the earnings reports—have been ignored.

The managers judge the operating manipulations more favorably because the earnings numbers are indicative of what actually took place. The operating manipulations have changed reality, and "truth" is fairly reported.

We see flaws in that reasoning. One is that the truth has not necessarily been disclosed completely. When sales and profits are borrowed from the future, for example, it is a rare company that discloses the borrowed nature of some of the profits reported.

A second flaw in the reasoning about the acceptability of operating manipulations is that it ignores a few or all of the effects of some types of operating manipulations on the full range of stakeholders. Many managers consider operating manipulations as a kind of "victimless crime."

But victims do exist. Consider, for example, the relatively common operating manipulation of early shipments. As one manager told us:

> *"Would I ship extra product if I was faced with a sales shortfall? You have to be careful there; you're playing with fire. I would let whatever happened fall to the bottom line. I've been in companies that did whatever they could to make the sales number, such as shipping lower quality product. That's way too short term. You have to draw the line there. You must maintain the level of quality and customer service. You'll end up paying for bad shipments eventually. You'll have returns, repairs, adjustments, ill will that will cause you to lose the account . . . [In addition] it's tough to go to your employees one day and say ship everything you can and then turn around the next day and say that the quality standards must be maintained."*

Another reported:

> *"We've had to go to [one of our biggest customers] and say we need an order. That kills us in the negotiations. Our last sale was at a price just over our cost of materials."*

These comments point out that customers—and sometimes even the corporation—may be victims.

Without a full analysis of the costs of operating manipulations, the dangers of such manipulations to the corporation are easily underestimated. Mistakes will be made because the quality of information is misjudged. The short term will be emphasized at the expense of the long term. If managers consistently manage short-term earnings, the messages sent to other employees create a corporate culture that lacks mutual trust, integrity, and loyalty.

A Lack of Moral Agreement

We also are troubled by the managers' inability to agree on the types of earnings-management activities that are acceptable. This lack of agreement exists even within corporations.

(continued)

Case 2-2

THE DANGEROUS MORALITY OF MANAGING EARNINGS (Continued)

What this suggests is that many managers are doing their analyses in different ways. The danger is obfuscation of the reality behind the financial reports. Because managers are using different standards, individuals who try to use the information reported may be unable to assess accurately the quality of that information.

If differences in opinions exist, it is likely that financial reporting practices will sink to their lowest and most manipulative level. As a result, managers with strict definitions of what is moral and ethical will find it difficult to compete with managers who are not playing by the same rules. Ethical managers either will loosen their moral standards or fail to be promoted into positions of greater power.

Actions for Concerned Managers

We believe most corporations would benefit if they established clearer accounting and operating standards for all employees to follow. The standard-setting process should involve managers in discussions of the practices related to short-term earnings measurements.

Until these standards are in place, different managers will use widely varying criteria in assessing the acceptability of various earnings-management practices. These variations will have an adverse effect on the quality of the firm's financial information. Companies can use a questionnaire similar to the one in our study to encourage discussion and to communicate corporate standards and the reason for them.

Standards also enable internal and external auditors and management to judge whether the desired quality of earnings is being maintained. In most companies, auditors can depend on good standards to identify and judge the acceptability of the operating manipulations.

Ultimately, the line management chain-of-command, not auditors or financial staff, bears the primary responsibility for controlling operating manipulations. Often managers must rely on their prior experience and good judgment to distinguish between a decision that will have positive long-term benefits and one that has a positive short-term effect but a deleterious long-term effect.

Finally, it is important to manage the corporate culture. A culture that promotes openness and cooperative problem solving among managers is likely to result in less short-term earnings management than one that is more competitive and where annual, and even quarterly, performance shortfalls are punished. A corporate culture that is more concerned with managing for excellence rather than for reporting short-term profits will be less likely to support the widespread use of immoral earnings-management practices.

Required

a. Time, laws, regulation, and professional standards have restricted accounting practices to those that are moral, ethical, fair, and precise. Comment.
b. Most managers surveyed had a conservative, strict interpretation of what is moral or ethical in financial reporting. Comment.
c. The managers surveyed exhibited a surprising agreement as to what constitutes an ethical or unethical practice. Comment.
d. List the five generalizations from the findings in this study relating to managing earnings.
e. Comment on management's ability to manage earnings in the long run by influencing financial accounting.

Case 2-3

FIRM COMMITMENT?

In the early 1980s, airlines introduced frequent-flier awards to develop passenger loyalty to a single airline. Free tickets and possibly other awards were made available to passengers when they accumulated a certain number of miles or flights on a particular air carrier. These programs were potentially good for the passenger and the airline as long as the awards were not too generous and the airlines could minimize revenue displacement from a paying passenger.

These programs were introduced by American Airlines in 1981. Originally, there were no restrictions. Anyone with the necessary miles could take any flight that had an available seat.

(continued)

Case 2-3 FIRM COMMITMENT? (Continued)

In the late 1980s, most airlines changed their no-restriction programs to programs with restrictions and blackout days. The airlines also added partners in frequent-flier programs, such as car rental companies and hotels. These partners handed out frequent-flier miles compensating the airlines in some manner for the miles distributed. Airlines also added triple-mileage deals.

A consequence of these expanding frequent-flier programs was a surge in the number of passengers flying free and a surge in unused miles. To get a handle on the cost and the unused miles, airlines increased the frequent-flier miles needed for a flight and placed time limits on the award miles.

The increased frequent-flier miles needed for a flight and the time limits prompted lawsuits. Many of these lawsuits were filed in state courts. One of the suits filed in the District Court in Chicago in 1989 made its way to the U.S. Supreme Court. In 1995, the Supreme Court ruled that federal airline deregulation law would not bar the breach-of-contract claim in the state court. In June of 1995, a District Court in Dallas ruled in favor of the airline in a case involving an increase in miles needed to earn a trip. Airlines interpret this decision as upholding their right to make changes to their frequent-flier programs.

Required

a. In your opinion, are the outstanding (unused) miles a liability to the airline? (Substantiate your answer.)
b. Comment on the potential problems involved in estimating the dollar amount of any potential liability.
c. 1. What is a contingent liability?
   2. In your opinion, are unused miles a contingent liability to the air carrier?
   3. Recommend the recognition (if any) for unused miles.

Case 2-4 RULES OR FEEL?

The FASB and the IASB have made progress towards convergence. The IFRS standards are considered to be more principles based than the U.S. rules-based GAAP. As of 2007, the IFRSs filled approximately 2,000 pages of accounting regulations.* When an IFRS or interpretation does not exist, then judgment must be used when applying an accounting policy.

As of 2007, U.S. GAAP comprised over 2,000 separate pronouncements.† Many of the U.S. pronouncements were dozens of pages, issued by numerous bodies.‡

Required

a. "The IFRS standards are considered to be more principles based than the U.S. rules-based GAAP." Comment on the implications of this statement, including the legal implications.
b. U.S. GAAP has been considered by many to be the best GAAP in the world. Should the United States give up its GAAP?

*Lawrence M. Gill, "IFRS: Coming to America," *Journal of Accountancy* (June 2007), p. 71.
†Ibid.
‡Ibid.

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Case 2-6

MANAGEMENT'S RESPONSIBILITY

3M* included these reports with its 2006 annual report:

Management's Responsibility for Financial Reporting

Management is responsible for the integrity and objectivity of the financial information included in this report. The financial statements have been prepared in accordance with accounting principles generally accepted in the Unites States of America. Where necessary, the financial statements reflect estimates based on management's judgment.

Management has established and maintains a system of internal accounting and other controls for the Company and its subsidiaries. This system and its established accounting procedures and related controls are designed to provide reasonable assurance that assets are safeguarded, that the books and records properly reflect all transactions, that policies and procedures are implemented by qualified personnel, and that published financial statements are properly prepared and fairly presented. The Company's system of internal control is supported by widely communicated written policies, including business conduct policies, which are designed to require all employees to maintain high ethical standards in the conduct of Company affairs. Internal auditors continually review the accounting and control system.

3M Company

Management's Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining an adequate system of internal control over financial reporting. Management conducted an assessment of the Company's internal control over financial reporting based on the framework established by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control—Integrated Framework*. Based on the assessment, management concluded that, as of December 31, 2006, the Company's internal control over financial reporting is effective.

*"3M is a diversified technology company with a global presence in the following businesses: industrial and transportation; health care; display and graphics; consumer and office; safety, security and protection services; and electro and communications." 10-K

(continued)

Case 2-6 MANAGEMENT'S RESPONSIBILITY (Continued)

Management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2006 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

3M Company

Required

a. Who has the responsibility for the financial statements?
b. What is the role of the accountant (auditor) as to the financial statements?
c. Accountants (auditors) are often included as defendants in lawsuits that relate to the financial statements. Speculate as to why this is the case.
d. Why did 3M include the report "Management's Report on Internal Control over Financial Reporting"?

Case 2-7 SAFE HARBOR

In 1995, Congress passed the Private Securities Litigation Reform Act (the Act). The principal provisions of the Act are intended to curb abusive litigation and improve the quality of information available to investors through the creation of a safe harbor for forward-looking statements.

Forward-looking statements were defined to include statements relating to projections of revenues and other financial items, plans and objectives, future economic performance, assumptions, reports issued by outside reviewers, or other projections or estimates specified by rule of the SEC. The safe harbor applies to both oral and written statements.

Management frequently uses signals as "we estimate," "we project," and the like, where forward-looking statements are not otherwise identified as such. The forward-looking statements must be accompanied by meaningful cautionary statements. The cautionary statement may be contained in a separate risk section elsewhere in the disclosure document.

Southwest Airlines Co.* included this statement with its 2006 Form 10-K.

Forward-Looking Statements

Some statements in this Form 10-K (or otherwise made by the Company or on the Company's behalf from time to time in other reports, filings with the Securities and Exchange Commission, news releases, conferences, World Wide Web postings or otherwise) which are not historical facts, may be "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, Section 21E of the Securities Exchange Act of 1934, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements are based on, and include statements about, Southwest's estimates, expectations, beliefs, intentions or strategies for the future, and the assumptions underlying these forward-looking statements. Specific forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts and include, without limitation, words such as "anticipates," "believes," "estimates," "expects," "intends," "forecasts," "may," "will," "should," and similar expressions. Forward-looking statements are not guarantees of future performance and involve risks and uncertainties that are difficult to predict. Therefore, actual results may differ materially from what is expressed in or indicated by Southwest's forward-looking statements or from historical experience or the Company's present expectations. Factors that could cause these differences include, but are not limited to, those set forth under item 1A–Risk Factors.

*"Southwest Airlines Co. is a major passenger airline that provides scheduled air transportation in the United States." 10-K

(continued)

Case 2-7 SAFE HARBOR (Continued)

Caution should be taken not to place undue reliance on the Company's forward-looking statements, which represent the Company's views only as of the date this report is filed. The Company undertakes no obligation to update publicly or revise any forward-looking statement.

Required

a. Demand for financial reports exists because users believe that the reports help them in decision making. In your opinion, will forward-looking statements as provided by the Private Securities Litigation Reform Act aid users of financial reports in decision making?

b. To some extent, investors' rights are limited by the curb of abusive litigation. In your opinion, is there a net benefit to investors from a safe harbor for forward-looking statements?

Case 2-8 ENFORCEMENT

This case includes a news release issued by the Public Company Accounting Oversight Board. This news release comments on the first disciplines of an accounting firm and auditors under the Sarbanes-Oxley Act of 2002.

Board Revokes Firm's Registration, Disciplines Three Accountants for Failure to Cooperate

Washington, DC, May 24, 2005—The Public Company Accounting Oversight Board today revoked the registration of a public accounting firm and barred the firm's managing partner from association with a registered accounting firm after finding that they concealed information from the Board and submitted false information in connection with a PCAOB inspection.

The Board also censured two former partners in the firm, finding that they participated in the misconduct but noting that they promptly alerted the PCAOB and cooperated in the Board's investigation.

"Registered accounting firms and their associated persons have a duty to cooperate in PCAOB inspections," said Claudius Modesti, director of the PCAOB's Division of Enforcement and Investigations. "The findings in this case demonstrate that the Board will not tolerate conduct aimed at thwarting the Board's inspections."

The accounting firm, Goldstein and Morris CPAs, P.C., based in New York City, was notified in September 2004 that the firm would be inspected by the PCAOB in November 2004.

The PCAOB's Division of Registration and Inspections directed a request for information and documents to the firm's managing partner, Edward B. Morris. The Board found that, in responding to the request, Mr. Morris and two partners, Alan J. Goldberger and William A. Postelnik, were aware that the firm had prepared the financial statements of two of its public company audit clients, contrary to auditor independence requirements of federal law. The Board found that Messrs. Morris, Goldberger, and Postelnik took steps to conceal that fact from the Board by omitting certain requested information from the firm's written response to the inspection request.

The Board also found that the partners, after learning of the imminent inspection, formulated and carried out a plan to create and back-date certain documents and place them in the firm's audit files. The Board found that Messrs. Morris, Goldberger, and Postelnik took these steps to conceal from the Board the firm's failure to comply with certain auditing standards.

Messrs. Goldberger and Postelnik notified the PCAOB of the omitted and falsified information. Both resigned from the firm.

The accounting firm and Mr. Morris consented to a Board order making the findings and imposing sanctions, without admitting or denying the findings. The order bars Mr. Morris from association with a registered accounting firm and revokes the firm's registration. Firms that are not registered with the PCAOB are prohibited from auditing the financial statements of public companies.

(continued)

Case 2-8 ENFORCEMENT (Continued)

Messrs. Goldberger and Postelnik each consented to a Board order making the findings and imposing the censures without admitting or denying the findings. The Board limited the sanctions of the two men to censures because they "promptly and voluntarily brought the matter to the Board's attention, disclosed their own misconduct and the misconduct of others, and made affirmative efforts to provide the Board with relevant information."

The Board's orders are available under Enforcement at www.pcaobus.org.

Suspected misconduct by auditors can be reported to the PCAOB Center for Enforcement Tips, Complaints and Other Information by e-mail or by phone to 800-741-3158.

Media Inquiries: Public Affairs, 202-207-9227

Required

a. Does it appear that Mr. Morris and the accounting firm can continue to function in public accounting? Comment.

b. It appears that Mr. Morris, Goldberger, and Postelnik can continue to function as certified public accountants. Speculate on what may happen to their ability to function as certified public accountants. (*Hint:* Certification is granted by individual states.)

Case 2-9 WATCH—DOLLARS—AUDITING STANDARDS—GAAP

Information reported in some Canadian companies' 2006 annual reports follows:

1. Enbridge Inc.
2. Baytex Energy Trust
3. Algoma Steel Inc.

1. Enbridge Inc.

Corporate Head Office
3000, 425—1st Street S.W.
Calgary, Alberta, Canada T2P3L8

Exchange Listing

Enbridge common shares trade on the Toronto Stock Exchange in Canada and on the New York Stock Exchange in the United States under the symbol "ENB."

Management's Report (in Part)

"The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles . . . PricewaterhouseCoopers LLP, independent auditors appointed by the shareholders of the Company, conducts an examination of the consolidated financial statements in accordance with Canadian generally accepted auditing standards."

Auditor's Report (in Part)

"In accordance with Canadian generally accepted auditing standards and the standards of The Public Company Accounting Oversight Board (United States) . . . in accordance with Canadian generally accepted accounting principles."

Enbridge Inc.

Consolidated Statements of Earnings (in Part)
(Millions of Canadian dollars, except per share amounts)

(continued)

Case 2-9 WATCH—DOLLARS—AUDITING STANDARDS—GAAP (Continued)

Notes to the Consolidated Financial Statements (in Part)

"Enbridge, Inc. . . . is one of North America's largest energy transportation and distribution companies."

1. Summary of Significant Accounting Policies (in Part)

"The consolidated financial statements of the Company are prepared in accordance with Canadian generally accepted accounting principles (Canadian GAAP). These accounting principles are different in some respects from United States generally accepted accounting principles (U.S. GAAP) and the significant differences that impact the company's financial statements are described in Note 26. Amounts are stated in Canadian dollars unless otherwise noted."

2. Baytex Energy Trust

Corporate Head Office
Suite 2200, Bow Valley Square II
205—5th Avenue S.W.
Calgary, Alberta, Canada T2P2U7

Exchange Listing

Toronto Stock Exchange
New York Stock Exchange

Management's Report (in Part)

"Management, in accordance with Canadian generally accepted accounting principles"

Auditor's Report (in Part)

"We conducted our audits in accordance with Canadian generally accepted auditing standards . . . conducted in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Oversight Board (United States) on the consolidated financial statements for the same period, prepared in accordance with Canadian generally accepted accounting principles but which included Note 17, Differences Between Canadian and United States Generally Accepted Accounting Principles."

Baytex Energy Trust

Consolidated Statements of Operations and Deficit (in Part)
Years Ended December 31 (thousands, except per unit data)

Note to the Consolidated Financial Statements (in Part)

Years ended December 31, 2006 and 2005
(All tabular amounts in thousands of Canadian dollars, except per unit amounts)

1. Basis of Presentation (in Part)

   "Baytex Energy Trust (the 'Trust') was established on September 2, 2003 under a plan of arrangement involving the trust and Baytex Energy Ltd. (the 'Company')."

   "The consolidated financial statements include the accounts of the trust and its subsidiaries and have been prepared by management in accordance with Canadian generally accepted accounting principles ('GAAP') as described in note 2."

(continued)

Case 2-9 WATCH—DOLLARS—AUDITING STANDARDS—GAAP (Continued)

17. Differences Between Canadian and United States Generally Accepted Accounting Principles (in Part)

    "The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in Canada ('Canadian GAAP'). The significant differences between Canadian and United States GAAP, as applicable to these consolidated financial statements and notes, are described in the trust's Form 40-F, which is filed with the United States Securities and Exchange Commission."

3. Algoma Steel Inc.

Corporate Head Office
Sault Ste. Marie
Ontario, Canada P6A7B4

Share Listings

Algoma Steel Inc. trades on the Toronto Stock Exchange under the symbol AGA.

Management's Responsibility for Financial Reporting (in Part)

"The consolidated financial statements of Algoma Steel Inc. ('Algoma') have been prepared in accordance with Canadian generally accepted accounting principles."

Auditor's Report to the Shareholders (in Part)

"We conducted our audits in accordance with Canadian generally accepted auditing standards . . . in accordance with Canadian generally accepted accounting principles."

Algoma Steel Inc.

Consolidated Statements of Income and Retained Earnings (in Part)
Expressed in millions of Canadian dollars, except per share amounts

Notes to Consolidated Financial Statements (in Part)

1. Nature of Operations

   "Algoma Steel Inc. is an integrated steel producer with operations located entirely in Canada. The Company produces sheet and plate products that are sold primarily in Canada and the United States."

2. Summary of Significant Accounting Policies (in Part)

   "The consolidated financial statements have been prepared by the Company with Canadian generally accepted accounting principles."

Required

a. Indicate if Canadian or U.S. dollars are used for these companies' financial statements.
   1. Enbridge Inc.
   2. Baytex Energy Trust
   3. Algoma Steel Inc.
b. Indicate if Canadian or U.S. GAAP was used for these companies.
   1. Enbridge Inc.
   2. Baytex Energy Trust
   3. Algoma Steel Inc.

(continued)

Case 2-9 WATCH—DOLLARS—AUDITING STANDARDS—GAAP (Continued)

c. Indicate if Canadian or U.S. generally accepted auditing standards were used for these companies.
   1. Enbridge Inc.
   2. Baytex Energy Trust
   3. Algoma Steel Inc.
d. Can the operating results be determined in U.S. GAAP? Comment on each.
   1. Enbridge Inc.
   2. Baytex Energy Trust
   3. Algoma Steel Inc.
e. Consider the stock exchanges where the respective shares are listed. Does the stock exchange used contribute to the complexity? Comment.

Case 2-10 MULTIPLE COUNTRY ENFORCEMENT*

SEC Charges Royal Ahold and Three Former Top Executives with Fraud; Former Audit Committee Member Charged with Causing Violations of the Securities Laws for Immediate Release

2004-144

Washington, D.C., Oct. 13, 2004—The Securities and Exchange Commission today announced the filing of enforcement actions alleging fraud and other violations against Royal Ahold (Koninklijke Ahold N.V.) (Ahold) and three former top executives: Cees van der Hoeven, former CEO and chairman of executive board; A. Michiel Meurs, former CFO and executive board member; and Jan Andreae, former executive vice president and executive board member. The Commission also charged Roland Fahlin, former member of Ahold's supervisory board and audit committee, with causing violations of the reporting, books and records, and internal controls provisions of the securities laws.

The SEC's complaints, filed in the United States District Court for the District of Columbia, allege that, as a result of the fraudulent inflation of promotional allowances at U.S. Foodservice, Ahold's wholly-owned subsidiary, the improper consolidation of joint ventures through fraudulent side letters, and other accounting errors and irregularities, Ahold's original SEC filings for at least fiscal years 2000 through 2002 were materially false and misleading. For fiscal years 2000 through 2002, Ahold overstated net sales by approximately EUR 33 billion ($30 billion). For fiscal years 2000 and 2001 and the first three quarters of 2002, Ahold overstated operating income by approximately EUR 3.6 billion ($3.3 billion) and net income by approximately EUR 900 million ($829 million).

The Commission has not sought penalties in the enforcement actions against the individuals because the Dutch Public Prosecutor's Office, which is conducting a parallel criminal investigation in The Netherlands, has requested that the Commission not seek penalties against the individuals because of potential double jeopardy issues under Dutch law. Because of the importance of this case in The Netherlands and the need for continued cooperation between the SEC and regulatory authorities in other countries, the Commission has agreed to the Dutch prosecutor's request.

Required

a. Why can the SEC charge a company in The Netherlands with U.S. security violations?
b. Why is The Netherlands conducting a parallel criminal investigation?
c. Speculate on how many countries may be running a parallel criminal investigation relating to securities sold.

*Dr. Thomas Klein, Emeritus, the University of Toledo, assisted with this case.

Case 2-11

NOTIFY THE SEC

Summary

"This matter involves Hewlett-Packard's failure to disclose the circumstances surrounding a board member's resignation amidst the company's controversial investigation into boardroom leaks. On May 18, 2006, HP's Board of Directors learned the findings of the company's leak investigation and voted to request the resignation of a director believed to have violated HP's policies by providing confidential information to the press. Silicon Valley venture capitalist and fellow director Thomas Perkins (not the source of the leak) voiced his strong objections to the handling of the matter, announced his resignation, and walked out of the Board meeting. Contrary to the reporting requirements of the federal securities laws, HP failed to disclose to investors the circumstances of Mr. Perkins' disagreement with the company."*

Required

a. What form reviewed in this chapter would be used to disclose the resignation of a board member?

b. Comment on why it would be in the public interest to know the circumstances surrounding the resignation of this board member.

*SEC Administrative Proceeding, File No. 3-12643, May 23, 2007.

Web Case

Thomson One *Business School Edition*

Please complete the Web case that covers material discussed in this chapter at academic.cengage .com/accounting/Gibson. You'll be using Thomson One Business School Edition, a powerful tool, that combines a full range of fundamental financial information, earnings estimates, market data, and source documents for 500 publicly traded companies.

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