Chapter One

ACCOUNTING PRINCIPLES AND THE LEGAL CONTEXT

Suppose that a clause in your client’s contract entitles him to compensation in an amount equal to a stated percentage of the “net profits” earned from a product he helped to create. The other party to the contract informs him that the amount of net profits on the product has been negative and so claims it owes him nothing. Your client is dismayed, because he had been led to understand from reports in the news media that the product had been a spectacular success, with tens of millions of people lining up for it and paying a total of nearly $200 million to enjoy it.

On behalf of your client, you request the other party to send you documentary evidence defending its claim that net profits had been negative. The other party sends you a one-page document, captioned “Financial Statement,” which contains a list of numbers. Lo-and-behold, at the bottom of the page on a line called “net profits,” there it is in black-and-white—net profits on the product were negative $18 million. The document is signed by an independent firm, as called for by the contract. You compare the definition of the term net profits in the contract with the list of numbers and find that they are in accord with each other. You do what may seem the obvious thing—you call your client and comfort him because, alas, his case is easy and over. He has no claim.

But wait. Suppose that the contract or the financial statement you have been given is not what it seems. Suppose that the term “net profits” as used in the contract and followed scrupulously in the financial statement is distorted in some way. What if the term net profit in the contract implied to an ordinarily intelligent reader of the English language that your client would be paid a percentage of the amount by which revenues fairly attributable to the product were greater than expenses fairly incurred to create and market it? And what if the net profits reported on the financial statement you have been furnished were
computed according to some other method that departed from that ordinary understanding? Would your client have some claim after all, either under his contract or otherwise?

To be more concrete, suppose your client were well-known humorist and writer Art Buchwald and the contract was with the movie studio, Paramount Pictures. Suppose the contract granted Paramount the rights to the idea for the film Coming to America, starring Eddie Murphy, in exchange for Mr. Buchwald's right to payment equal to a stated percentage of that film's net profits. And suppose finally that the film had been a blockbuster hit, generating $160 million in worldwide box-office receipts, and that it had been widely reported in film-industry trade publications that the film cost a fraction of that to make. Any claim now?

At stake in this case is your client's claim. But more broadly, at stake is the manner in which events in the real world are reported in terms of summary, numerical statements about that reality. In the case of the film Coming to America, Mr. Buchwald sued Paramount. Mr. Buchwald's lawyers argued in part that the clause of the contract concerning the determination of "net profits" was substantively unconscionable. In particular, the argument ran, the way in which net profits were to be calculated under the contract understated revenues reasonably attributable to the film and overstated expenses reasonably associated with producing it. Although cases holding contract terms to be substantively unconscionable are rare, a California court agreed with Mr. Buchwald's lawyers that this was such a case. How did Mr. Buchwald's lawyers know that this strategy might have a chance of legal success and what enabled them to make the winning argument? They knew accounting.

Problems like this are not limited to that one film, or to Hollywood (but think of Batman or Forrest Gump). They arise in virtually every context in which financial issues are implicated. Those contexts include not only film-making, but royalty agreements on intellectual property of all kinds, divorce settlements, child custody agreements, collective bargaining agreements, employment agreements, sports franchise and partnership agreements, loan agreements, bankruptcy plans of reorganization, the purchase or sale of a business entity, and virtually every other situation in which money is at stake. To be frank (if slightly overstated): almost every situation worth negotiating about or litigating over!

In all these matters, lawyers play a role. And of course explicit legal issues must be resolved in the course of negotiating and resolving such matters—the definition of a property right, the requirements of contract formation, the allocation of risk of tort liabilities, and so on. But important as they are, these issues are far less likely to be at the center of the discussions. The focus of the negotiations or dispute will instead most likely be on the financial issues. In terms of your training during the first year of law school, the "facts" at the center of discussion will be
financial, and in terms of relative importance in the universe you undoubtedly know that the facts dominate the law. To be an effective advocate on your client's behalf, therefore, an understanding of financial issues and how they are reported and described is crucial. This book is an introduction to the world defined by the facts in these terms.

To begin the introduction, consider the following hypothetical problem of how to report a series of very basic events concerning a new business operation.

**Problem 1—An Introduction**

Annie and Marta formed KFC (Hungary), Inc. ("KFC") to operate a Kentucky Fried Chicken Franchise in Budapest. Annie and Marta invested $600,000 in KFC. During Year 1, KFC engaged in the following transactions:

1. KFC spent $50,000 training a Hungarian staff to operate the planned store in the manner required by KFC's franchise agreement.

2. KFC ordered equipment from German manufacturers, agreeing to pay the equivalent of $150,000 on delivery. At the time the equipment was delivered, its market value had increased to $180,000, due to changes in exchange rates and to inflation.

3. KFC's bank credited $40,000 to KFC's account, representing interest earned by KFC on the amount on deposit in its account.

Assuming KFC engaged in no other transactions in Year 1, what would you say was the value of KFC at the end of Year 1? How much would you say KFC earned (or lost) in Year 1? What additional information, if any, would you need to answer these questions? Consider the following additional questions posed by these general ones.

First, how does one treat the initial investment of $600,000? One impulse might be to treat it as earnings and an alternative would be to characterize it as a cash investment (capital investment—common stock).

Second, how does one treat $50,000 spent training employees? Several possibilities seem plausible: as a one-time expense (that reduces earnings now); as an expense to be recognized periodically over time (called amortizing, which would reduce earnings over time); or to treat it as an asset (by recognizing that it offers continuing value to the business over time).

Third, how does one treat the equipment that was bought and delivered? Again several possibilities seem plausible: to value it at cost ($150,000); to value it at market ($180,000); or to reduce its value for depreciation (say to $140,000).

Fourth, how does one treat interest earned from the bank? It could be treated as earnings like payments received from customers; or it could
be considered as a *special kind of earnings* since it does not arise from the management of the business to which the franchise is directed—frying and selling chicken.

**A. INTRODUCTION TO GAAP**

While the various treatments suggested for each of the events in the foregoing Problem 1 seem plausible, notice that they lead to many very different answers for what the company earned and what its year-end value is. As a result, the reports of earnings and of value are not at all meaningful without a thorough understanding of all the choices that were made in order to reach them. If the resulting reports are to have meaning, it would therefore seem desirable to establish “answers” for how to treat each of these events. That way, the bottom line numbers can be a reliable basis for understanding how well or poorly the entity is doing compared to prior periods, compared to expectations about it, or compared to other entities. This is a major purpose of accounting, achieved through the promulgation and use of a unified body of principles designed to deal with the infinite variety of transactions with which accounting must contend.

*GAAP and FASB.*

Those principles are embodied in a set of accounting guidelines called *generally accepted accounting principles* (which are referred to by the acronym “GAAP” and pronounced gap). The principles contained in GAAP are the product of agreement among leading members of the accounting profession, a group called the Financial Accounting Standards Board (which is referred to by the acronym “FASB” and pronounced faz-bee). FASB was formed in 1973 as an independent body composed of board members drawn from certified public accountants, corporate executives, financial analysts and academics. Accordingly, GAAP are necessarily the result of choices FASB made among competing principles they could have adopted. In other words, there is no reason to believe that the choices are the product of any scientific process that can be verified *a priori*. They are instead conventions, the primary purpose of which is to facilitate the comparability of financial statements among business entities and with respect to a particular business entity over time.

One important consequence that follows from these observations is that it is possible that there can be more than one “right” way of accounting for a certain kind of financial event. In many such cases, FASB has elected to permit alternative ways of handling the matter, but only so long as the chosen way is both one of those accepted under GAAP and is fully disclosed as part of the financial statements. Much of this book is concerned with trying to understand the basics of GAAP.
As a private organization, FASB’s promulgation of GAAP does not ipso facto bind accountants in a legal sense. On the other hand, however, as promulgated by the chief rulemaking body of the accounting profession, GAAP does define standards of practice and professional conduct that bears on the reasonableness of an accountant’s performance. In other words, GAAP may influence the legal definition of professional negligence for accountants. As a practical matter, moreover, GAAP is the language of business and persons with whom an entity deals—especially lenders and trade creditors—will often insist on receiving and reviewing financial statements that are prepared in accordance with GAAP before lending money or otherwise extending credit.

The SEC.

Apart from these indirect legal and practical consequences of FASB, the chief legal authority having jurisdiction over accounting rules and practice is the Securities and Exchange Commission (the SEC), a federal agency charged with administering the body of federal securities laws. The bulk of such laws center on prescribing the manner and timing of the disclosure of information about the financial condition and performance of business entities. Much of that disclosure is in turn driven by accounting rules and practice and therefore the SEC has a distinct interest in participating in the process of promulgating accounting rules, including GAAP. In general, however, the SEC has adopted a strong deferential stance towards the rulemaking power of FASB and tends to sanction, as a matter of law, the GAAP rules FASB promulgates. As a matter of practice, this has entailed a strong cooperative effort between FASB and the SEC in developing accounting principles.

The SEC has the power not only to specify the accounting rules that govern entities subject to its jurisdiction, but also to review the resulting financial statements and to bring legal proceedings of various kinds against those who fail to comply. Private rights of action also can be maintained under the federal securities laws for violations of those laws. Two of the most significant grounds for making claims under the federal securities are Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and related rules promulgated by the SEC thereunder. These provisions generally prohibit material misrepresentations in, or omissions from, informational documents required to be prepared by entities issuing securities to the public. The entity issuing the securities is subject to liability for violations of these provisions. Subject to certain defenses that will be noted in Chapter Thirteen, liability may also be imposed on others who participate in planning and consummating the transaction, including accountants, auditors, lawyers, and underwriters.

International Accounting Standards.

Outside the US, neither the SEC nor FASB has power to promulgate accounting standards. That responsibility is reposed in various regulato-
ry and professional organizations in each country. However, as cross
border transactions proliferate, increasing pressure has emerged to har-
monize GAAP with accounting standards accepted in other countries.
The National Securities Markets Improvements Act of 1996, for example,
required the SEC to report to Congress on progress being made in
developing international accounting standards. The SEC has been work-
ing with the International Accounting Standards Committee (IASC) for
nearly a decade to promulgate a core set of accounting pronouncements
constituting a comprehensive basis of international GAAP, an effort
encouraged by a range of governmental ministers, including the Finance
Ministers and Central Bank Governors of the G7 countries, as well as
the World Bank. To date, however, progress remains quite inchoate in
developing international accounting standards and this book limits itself
to considerations of US GAAP (referred to simply as GAAP).

Objectives and Foundational Principles.

In promulgating principles of general application or of application to
particular circumstances, FASB is guided by the following objectives that
financial accounting and reporting seeks to meet (set forth in Statement

1. To provide information useful to present and potential external
users—primarily investors and creditors and their advisors and
representatives so that they may make rational economic decisions;

2. To provide information relating to an entity's cash inflows and
outflows since these flows eventually trickle down to creditors (in
payment of debt) and investors (in payment of dividends); and

3. To provide information relating to assets, liabilities, and equity
and changes in them during each reporting period.

Each of these objectives is united by a few overarching qualitative
characteristics that accounting information should possess. The primary
qualities are relevance and reliability. Relevance requires that informa-
tion be recorded and presented on a timely basis, so that it may be used
both to forecast future performance and to aid in understanding past
performance. Reliability means that the information should be free from
error and bias, which requires that the numbers in terms of which
transactions are reported be accurate, and that those reports can be
verified by independent parties.

The secondary qualities are comparability and consistency. Compar-
ability means that users should be able to compare accounting informa-
tion of one entity with that of other similar entities using the same
accounting measures and with statements of the same entity over
succeeding periods of time. Consistency means that the entity should use
the same accounting methods and procedures from year to year or, if a
change is to be made, it be made only for justified reasons that are
disclosed as part of the financial reporting process.
In seeking to achieve the fundamental objectives of financial accounting and reporting and to attain the foregoing qualities of accounting information, FASB is in turn guided by a series of foundational principles or assumptions on which the entire architecture of GAAP ultimately rests. Chief among these foundational principles or assumptions are the following:

*the separate entity assumption*: the entity being reported on is regarded as distinct from those who own it, whether or not it is a separate entity for legal purposes;

*the going concern assumption*: the entity being reported on is assumed to be continuing in operation for an indeterminate period, as a going concern, and is not expected to terminate operations or liquidate its business;

*the time period assumption*: the entity's activities can be divided into discrete time periods (such as monthly, quarterly and annually);

*the matching principle*: items of revenue should be allocated to the period during which effort was expended in generating them, and items of expense should be allocated to the period in which the benefit from them will contribute to generating revenue;

*the monetary transactions principle*: the transactions to be reported must be capable of measurement in monetary terms based on some actual transaction;

*the recognition principle*: items of revenue should be recognized only when the entity has completed or virtually completed the exchange that generates the earnings;

*the principle of conservatism*: a preference for understating earnings, values, and cash flows, rather than for overstating them;

*the cost principle*: assets are to be reported at their historical cost (and not at higher market prices);

*the consistency principle*: within a set of financial statements, one must apply principles consistently—a preference against picking and choosing to apply different conventions to the same transactions being reported in financial statements; and

*the materiality principle*: information to be reflected in financial statements should be meaningful to users and not trivial.

Throughout your study of accounting, keep in mind the objectives accounting seeks to achieve, the qualities that should characterize accounting information, and the foundational principles on which GAAP rests. The foundational principles will be referred to repeatedly throughout this book as the basics of GAAP are presented. As you study those basic principles of accounting, and GAAP, it may occasionally occur to you that the rules FASB has chosen do not always seem to be the product of logic, intuition, fairness, or reality! When that occurs to you,
return to the foregoing list of foundational principles and assumptions on which GAAP rests, the objectives it seeks to meet, and the qualities it seeks to promote. Then ask yourself whether the principle that is troubling you is defensible in terms of those ideas.

B. THE COMPONENTS OF FINANCIAL STATEMENTS

An important minimum requirement to achieve the objective of comparability between financial statements of different enterprises is that the format of the presentation be the same. Accountants have devised four basic forms for the presentation: the balance sheet, the income statement, the statement of retained earnings, and the statement of cash flows. These are the main documents that compose what is usually meant by financial statements.

These four chief financial statements report the financial and other information necessary for shareholders, creditors, and anyone else who deals with the business to evaluate the entity’s financial condition and performance. The financial statements are prepared from the internal day-to-day records of the entity by the employees and managers of the entity. The day-to-day records are maintained by recording the financial transactions in which the entity engages each day. Those daily transactions are periodically summarized, usually at the end of each month, then quarterly, and then cumulatively at the end of each year. It is on the basis of those daily records and the periodic summaries that the financial statements are ultimately prepared. Annual financial statements are prepared with respect to a fiscal year, which may be the calendar year (ending on December 31) or may be defined to end on some other date depending on the nature of the entity’s business operations.

The annual financial statements in turn usually form a part of an annual report that also includes a narrative commentary on the financial condition and performance of the entity for the year and summary reports of other statistical data. An example of a set of financial statements is included in the Appendix. You will find it essential to refer to the Appendix periodically as you study the succeeding materials, whether or not referenced directly in the text materials. In particular, as you read the following descriptions of the four principal financial statements, you should examine each such statement in the Appendix to begin to get a feel for the content of these various statements and the relationship between them.

The Balance Sheet.

The balance sheet is like a snapshot of an entity at a specific date. It is intended to reflect the financial condition of that entity as of that
specific date. It lists the entity’s assets as of a specified date and the entity’s liabilities as of that date and then shows the difference between these totals.

Assets are defined by FASB as “probable future economic benefits obtained or controlled by an entity resulting from past transactions or events.”

Liabilities are defined by FASB as “probable future sacrifices of economic benefits arising from present obligations to transfer assets or render services in the future.”

Equity is defined by FASB as “the residual interest in assets of an entity after subtracting its liabilities” from its assets. Equity represents the net ownership interest in the entity, and for that reason is often called “owners’ equity.” It represents both the initial investments made by the entity’s owners as well as the entity’s increases in income that it reinvests in the business.

As a matter of convention, the assets are listed on the balance sheet in the order of their liquidity, beginning with cash (the very definition of liquid), and going through to such relatively illiquid assets as real property, and other things not expected to be converted into cash for a significant period of time. Similarly, the liabilities are listed on the balance sheet beginning with obligations having the shortest due date (such as accounts payable, usually due in 30 days) through those with the longest due date (such as long term bonds, often not due for 10 or more years). The owner’s equity is listed next and it will always equal the total assets minus the total liabilities.

Financial statements usually include a balance sheet for two succeeding reporting periods, such as two succeeding months or two succeeding years, so that users can compare changes in the financial condition of the entity from one period to the next. We will consider the balance sheet in some detail beginning in the next Chapter and throughout the book.

The Income Statement.

The income statement is like a motion picture of the enterprise over a defined period of time, such as one year, and is intended to reflect the financial performance of the entity during that period of time. It lists the total revenues generated by the entity during the period and the total expenses incurred by the entity during that period and then shows the difference between these totals.

Revenues are defined by FASB as “increases in equity resulting from asset increases and/or liability decreases from delivering goods or services or other activities that constitute the entity’s ongoing major or central operations.” Revenues therefore “cover sales of merchandise, rendering of services, sales of securities by
a securities dealer, sales of buildings and land by a real estate
developer, rentals of commercial buildings and land by real
property owners, and dividends and interest earned by financial
institutions—all of which represent the entity's major or central
operations."

*Expenses* are defined by FASB as "decreases in equity from asset
decreases or liability increases from delivering goods or services,
or carrying out any activities which constitute the entity's
ongoing major or central operations." Expenses therefore "cover
cost of goods manufactured and sold, selling and administra-
tive expenses, and interest expense of financial institutions."

The difference between revenue and expense during each reporting
period is called the entity's *net income* for the period. It is a measure of
the financial performance of the entity during the period. The net
income is also referred to as *earnings* and can be broken down according
to the portion allocable to each ownership interest in the entity, a
breakdown called *earnings per share*.

Financial statements usually include an income statement for three
succeeding reporting periods, so that users can evaluate changes in the
financial performance of the entity over several periods. We will consider
the income statement in some detail beginning in the next Chapter and
throughout the book.

*The Statement of Retained Earnings.*

An entity can choose to allocate its net income with respect to any
reporting period between distributions to owners, as by the declaration
and payment of dividends, or to reinvestment in the business. To keep
track of the historical allocation between these uses, it is sometimes
desirable to prepare a separate financial statement called a statement of
retained earnings. It is the historical record of the portion of net
income—or equivalently, earnings—not paid out to owners. This state-
ment is not required by GAAP but it is required by federal securities
laws for public entities. We will consider the statement of retained
earnings in some detail in Chapter Seven, after we have thoroughly
explored the balance sheet and the income statement.

*The Statement of Cash Flows.*

The cash flow statement is also like a motion picture of the entity
over the same period covered by the income statement, only the lens of
the camera is more focused. It lists the total cash that flowed into the
entity during the period and the total cash that flowed out of the entity
during the period. These cash amounts may be different from the
revenue and expense amounts listed on the income statement because
not all items of revenue or expense are paid for in cash (for example,
some customers may buy goods from the entity on credit). The difference
between cash inflows and cash outflows is called free cash flow for the period, and gives a measure of an entity’s ability to pay its debts as they come due. We will consider this statement in some detail in Chapter Eight, also after we have thoroughly explored the balance sheet and the income statement, as well as the statement of retained earnings.

Footnotes.

Most information necessary to understanding the financial condition of a business at a moment in time, its financial performance over a period of time, and its ability to pay its debts as they come due can be reflected in (and therefore gleaned from) the balance sheet, the income statement, and the cash flow statement, respectively. But not all of it. When other information is important, it can be presented in a number of supplementary formats as part of these three basic financial statements. Chief among these are explanations and elaborations of the presentation in the basic financial statements in the form of footnotes accompanying those basic documents. As any budding lawyer will know, sometimes the most important information in any document is contained in footnotes, and the financial statements are no exception. As you consider in the ensuing Chapters of this book circumstances in which GAAP permits more than one method of accounting for a particular transaction, it will be helpful to peruse the financial statements in the Appendix, and the footnotes, to see how the footnotes relate to those principles. We will consider the significance of footnote disclosure in financial statements in Chapter Six and in other parts of this book.

The Auditor’s Report.

To obtain some objective assurance that the financial statements are relevant and reliable, an independent accounting firm can be hired to “audit” the financial statements. The audit takes the form of a general review of the financial statements and the underlying day-to-day records and periodic summaries on which they are based. As such, it is a kind of monitoring mechanism and is an important device that can lend credibility to the financial statements. Virtually all entities of any significant size have their annual financial statements audited, and all public entities are required by federal securities law to do so. Other businesses are not required by law to have their financial statements audited, but often it is necessary for them to do so as a practical matter in order to attract investors into the business or to establish other relationships with third parties.

A number of large accounting firms, as well as many other firms of various smaller sizes, are in engaged in the business of auditing financial statements. Substantial consolidation in the auditing industry has occurred in recent decades, reducing the number of these very large
organizations from eight to five. Can you name them?\(^1\) Numerous other firms are also very large but not as large as these to qualify for membership in this group of increasingly larger firms.

C. AUDITORS’ REPORTS

An audit conducted by an independent firm does not change the fact that an entity’s management prepares the financial statements and is responsible for them. The audit is a review of those statements made in accordance with a codified set of principles propounded by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA). These principles are called generally accepted auditing standards (and go by the acronym “GAAS,” pronounced gas). The auditor’s responsibility in connection with its review and analysis of the financial statements is summarized in a letter, called the auditor’s report, that accompanies the financial statements when finally released for use by investors, creditors, and other constituents of the entity. The standard form of that letter reads as follows:

**INDEPENDENT AUDITORS’ REPORT**

To the shareholders and directors of ABC Corporation:

We have audited the balance sheets of ABC Corporation as of December 31 [of the past two years] and the related statements of income and retained earnings and of cash flows for each of the three years in the period then ended. These financial statements are the responsibility of the Corporation’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an 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 financial statements referred to above present fairly, in all material respects, the financial position of ABC Corporation at December 31 [of the past three years] and the results of its operations and changes in its cash flows for the years then ended, in conformity with generally accepted accounting principles.

[Signed] Certified Public Accountants

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\(^1\) They are Andersen Worldwide, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Pricewaterhouse Coopers.
Unqualified Audit Reports.

Before considering the elements of this report, focus initially on the final paragraph, which announces the auditor's conclusion. In this example, the auditors have given the financial equivalent of a clean bill of health. Their opinion is that the financial statements "present fairly, in all material respects" the financial position in "conformity with" GAAP. This is called an "unqualified" audit report. Had the auditors found some departures from GAAP or determined that the financial statements did not constitute such a "fair presentation," then they would have been constrained to so state in the report. Auditor's reports that are not "unqualified" fall into three categories.

Qualified Audit Reports.

If the auditor is unable to say the statements were prepared in conformity with GAAP, but that they nevertheless constitute a fair presentation, then the auditor would issue a qualified opinion, stating the particular area of nonconformity with GAAP. A more severe situation arises where for whatever reason, whether due to nonconformity with GAAP or otherwise, the auditor cannot opine that the statements fairly present the financial condition of the entity. In that case, the auditor would issue a disclaimer, indicating that inability. The most severe situation arises where the auditor finds that the financial statements do not fairly present the financial condition of the entity in accordance with GAAP. In that case, the auditor would issue an adverse opinion. An adverse audit report is seen by anyone dealing with the entity as a red flag of caution and therefore carries potentially grave consequences for the entity.

Change in Accounting Principles.

A variation on the standard form of audit report that also constitutes a clean audit report is a statement in the report that discloses that the reporting entity has made changes in the principles of accounting it has applied during the reporting period. As we shall see, GAAP permits, and sometimes requires, that certain changes be made in the accounting principles applied from time to time. A change in the accounting principles an entity applies often has significant consequences for the presentation of its financial statements. When this happens, the audit report seeks to call attention to the change. It does not mean that an adverse opinion is being given. The audit report accompanying BIC Corporation's financial statements in the Appendix is an example of such a case, indicating a change in accounting principles applied with respect to
accounting for certain employee benefits (a subject we shall consider in Chapter Six).

**Textual Analysis of Audit Report.**

The foregoing text of the standard audit report has been in effect since 1989. As of that time, the report was revised into its current form as a result of a number of deficiencies seen to have been embodied in the report in use prior to that time. It is useful to consider what changes were made in 1989 to the report to understand the sorts of problems that at least at one time arose by the practice of the audit.

The second and third sentences of paragraph one were added to make it clear that the financial statements are prepared by and are the *responsibility of management*. Research in connection with preparing the revised report revealed a broad and significant misunderstanding about the nature of the audit. Many people apparently believed that the financial statements were prepared by outside accountants or by the Securities and Exchange Commission. This was an utterly mistaken belief and the first paragraph of the current report seeks to make it clear that the financial statements are prepared by, and are the responsibility of, the entity’s management.

The report also seeks to spell out more clearly the *limits of an audit*. This was because the public also misunderstood what an audit meant. Many people thought it meant a review of every financial transaction in which the entity had engaged during the period covered by the financial statements. This is not only untrue, it is a practical impossibility. Business entities engage in huge numbers of financial transactions during the course of the typical financial period, usually one year. Except in rare cases, it would be impossible for an auditor at the end of the year to review every single transaction. Instead, audits are conducted on a “test basis” by reviewing a sample of the hundreds or thousands of transactions of a variety of kinds engaged in by the firm over time. That is made clear in the report.

The report finally seeks to clarify at least somewhat the scope of the auditors’ responsibility with respect to the **detection of fraud**. The prior form of the report used language to the effect that the auditor’s responsibility was to assure that the statements “fairly” reflect the business or financial condition of the entity. This led to a number of lawsuits against auditors for failure to root out fraud. As a practical matter, however, the auditor is not always in a position to root out fraud. This is principally because it is simply not possible for the audit to include an examination of every single transaction in which an entity engaged or in which management says the entity has engaged. On the other hand, in addition to the portion of an audit that involves test sampling of such transactions, auditors also review the entity’s system of internal controls that are intended to assure the reliability of its financial statements. An
entity's internal controls include such devices as a requirement that all
disbursements of cash over a certain amount be approved by at least two
persons. The internal controls can therefore be seen as independent
mechanisms designed to deter and detect fraud.

Management Letters.

Based on the part of the audit that reviews an entity's internal
controls, the auditor issues a separate letter to the entity's management,
called a management letter. The management letter advises the entity's
management of any weaknesses discovered in the internal control mech-
anisms, or if true, indicates that none appeared. These letters are then
reviewed by the entity, usually by senior executives in the entity but in
cases where serious weaknesses are found to exist, also with the entity's
board of directors or at least a standing committee of the board, called
the audit committee. Management then issues a response to the manage-
ment letter and, depending on the seriousness of the reported weaknec-
es, may agree with the auditors on a plan for improving the internal
controls. Finally, to the extent the auditor discovers and reports serious
weaknesses in internal controls, it may find it necessary and desirable to
expand the scope of the test portion of the audit in light of those
weaknesses. In extreme cases, inadequate internal controls may con-
strain the auditor to issue a qualified opinion, disclosing that its opinion
is limited in scope.

The legal responsibilities of auditors in connection with audits, as
well as the role that lawyers play in the auditing process, are discussed
further in Chapter Thirteen. By the time you reach that Chapter, the
significance of those roles will be clearer and you will have the under-
standing necessary to appreciate what is at stake. Let's continue with
the project of building that understanding.