Chapter 2

The CPA Profession

■ Concept Checks

P. 28

1. The four major services that CPAs provide are:

   a. *Audit and assurance services* Assurance services are independent professional services that improve the quality of information for decision makers. Assurance services include attestation services, which are any services in which the CPA firm issues a report that expresses a conclusion about the reliability of an assertion that is the responsibility of another party. The four categories of attestation services are audits of historical financial statements, attestation on the effectiveness of internal control over financial reporting, reviews of historical financial statements, and other attestation services.
   b. *Accounting and bookkeeping services* Accounting services involve preparing the client's financial statements from the client's records. Bookkeeping services include the preparation of the client's journals and ledgers as well as financial statements.
   c. *Tax services* Tax services include preparation of corporate, individual, and estate returns as well as tax-planning assistance.
   d. *Management consulting and risk advisory services* These services range from suggestions to improve the client's accounting system to advice on risk management or on computer installations.

2. The six organizational structures available to CPA firms are proprietorship, general partnership, general corporation, professional corporation, limited liability company, and limited liability partnership. CPA firms are typically not organized as a general partnership because a general partnership offers less protection from legal liability relative to other structures such as a limited liability partnership.

P. 38

1. The Public Company Accounting Oversight Board provides oversight for auditors of public companies, including establishing auditing and quality control standards for public company audits, and performing inspections of the quality controls at audit firms performing those audits.

Concept Checks (continued)

2. The AICPA is the organization that sets professional requirements for CPAs. The AICPA also conducts research and publishes materials on many different subjects related to accounting, auditing, management consulting and advisory services, and taxes. The organization also prepares and grades the CPA examinations, provides continuing education to its members, and develops specialty designations to help market and assure the quality of services in specialized practice areas.

3. International Standards on Auditing (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) and are designed to improve the uniformity of auditing practices and related services throughout the world. AICPA Statements on Auditing Standards (SASs) are established by the Auditing Standards Board of the AICPA, and are applicable to private entities within the United States. As a result of efforts by the Auditing Standards Board of the AICPA to converge U.S. standards with international standards, AICPA auditing standards and International Standards on Auditing are similar in most respects. PCAOB Auditing Standards apply only to U.S. publicly traded companies and other SEC registrants, including broker-dealers. However, given that the PCAOB initially adopted existing standards established by the Auditing Standards Board as interim auditing standards, standards for audits of U.S. public and private companies are mostly similar.

■ Review Questions

2-1 The major characteristics of CPA firms that permit them to fulfill their social function competently and independently are:

1. *Organizational form* A CPA firm exists as a separate entity to avoid an employer-employee relationship with its clients. The CPA firm employs a professional staff of sufficient size to prevent one client from constituting a significant portion of total income and thereby endangering the firm's independence.
2. *Conduct* A CPA firm employs a professional staff of sufficient size to provide a broad range of expertise, continuing education, and promotion of a professional independent attitude and competence.
3. *Peer review* This practice evaluates the performance of CPA firms in an attempt to keep competence high.

2-2 The Public Company Accounting Oversight Board (PCAOB) was established by the Sarbanes-Oxley Act of 2002 in the wake of multiple accounting scandals and alleged audit failures, including those of Enron and WorldCom. The PCAOB provides oversight for auditors of public companies, including establishing auditing and quality control standards for public company audits, and performing inspections of the quality controls at audit firms performing those audits.

2-3 The purpose of the Securities and Exchange Commission is to assist in providing investors with reliable information upon which to make investment decisions. Since most reasonably large CPA firms have clients that must file reports with the SEC each year (all companies filing registration statements under the securities acts of 1933 and 1934 must file audited financial statements and other reports with the SEC at least once each year), the profession is highly involved with the SEC requirements.

The SEC has considerable influence in setting generally accepted accounting principles and disclosure requirements for financial statements because of its authority for specifying reporting requirements considered necessary for fair disclosure to investors. In addition, the SEC has power to establish rules for any CPA associated with audited financial statements submitted to the Commission.

2-4 *Statements on Standards for Attestation Engagements* provide a framework for attest engagements, including detailed standards for specific types of attestation engagements.

2-5 The PCAOB has responsibility for establishing auditing standards for U.S. public companies, while the Auditing Standards Board (ASB) of the AICPA establishes auditing standards for U.S. private companies. Prior to the creation of the PCAOB, the ASB had responsibility for establishing auditing standards for both public and private companies. Because existing auditing standards were adopted by the PCAOB as interim auditing standards for public company audits, there is considerable overlap in the two sets of auditing standards.

2-6 International Standards on Auditing (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) and are designed to improve the uniformity of auditing practices and related services throughout the world. The IAASB issues pronouncements on a variety of audit and attest functions and promotes their acceptance worldwide. As a result of efforts by the Auditing Standards Board to converge U.S. GAAS with international standards, AICPA auditing standards and International Standards on Auditing are similar in most respects.

2-7 Auditing standards represent the combination of the four principles and all the Statements on Auditing Standards (SASs) that are codified in the AU-C sections. The principles outlined in Figure 2-2 provide a framework for the auditing standards. Examples of auditing standards include any of the SASs (e.g., SAS No. 125), covering topics such as audit planning or assessing the risk of material misstatement.

Generally accepted accounting principles are specific rules for accounting for transactions occurring in a business enterprise. Examples may be any of the opinions of the FASB, such as accounting for leases, pensions, or fair value assets.

2-8 Auditors develop their competency and capabilities for performing an audit through formal education in auditing and accounting, adequate practical experience, and continuing professional education. Auditors can demonstrate their proficiency by becoming licensed to practice as CPAs, which requires successful completion of the Uniform CPA Examination. The specific requirements for licensure vary from state to state.

2-9 For the most part, auditing standards, including SASs, are general rather than specific. Many practitioners along with critics of the profession believe the standards should provide more clearly defined guidelines as an aid in determining the extent of evidence to be accumulated. This would eliminate some of the difficult audit decisions and provide a source of defense if the CPA is charged with conducting an inadequate audit. On the other hand, highly specific requirements could turn auditing into mechanical evidence gathering, void of professional judgment. From the point of view of both the profession and the users of auditing services, there is probably a greater harm from defining authoritative guidelines too specifically than too broadly.

2-10 Quality controls are the procedures used by a CPA firm that help it meet its professional responsibilities to clients. Quality controls are therefore established for the entire CPA firm as opposed to individual engagements.

2-11 The element of quality control is personnel management. The purpose of the requirement is to help assure CPA firms that all new personnel are qualified to perform their work competently. A CPA firm must have competent employees conducting the audits if quality audits are to occur.

2-12 A peer review is a review, by CPAs, of a CPA firm's compliance with its quality control system. A mandatory peer review means that such a review is required periodically. AICPA member firms are required to have a peer review every three years. Registered firms with the PCAOB are subject to quality inspections. These are different than peer reviews because they are performed by independent inspection teams rather than another CPA firm.

Peer reviews can be beneficial to the profession and to individual firms. By helping firms meet quality control standards, the profession gains if reviews result in practitioners doing higher quality audits. A firm having a peer review can also gain if it improves the firm's practices and thereby enhances its reputation and effectiveness, and reduces the likelihood of lawsuits. Of course, peer reviews are costly. There is always a trade-off between cost and benefits.

■ Multiple Choice Questions From CPA Examinations

2-13 a. (2) b. (3) c. (3)

2-14 a. (1) b. (2) c. (1)

■ Multiple Choice Questions From Becker CPA Exam Review

2-15 a. (1) b. (4) c. (3)

■ Discussion Questions And Problems

2-16 a. The main objective of an audit of financial statements is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion in a written report on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework.

b. No. In an audit of the financial statements, the auditor performs audit procedures to obtain reasonable assurance about whether the financial statements contain material misstatements. While a high level of assurance, reasonable assurance is less than a guarantee—which implies absolute (100%) assurance. In an audit, the auditor issues an opinion on whether the financial statements are presented fairly, but the auditor is not guaranteeing that the financial statements are accurate with certainty.

c. No. Fraud is a broad legal concept that describes any intentional deceit meant to deprive another person or party of their property or rights. The auditor does not take responsibility for detecting all types of fraud, given many types of fraud do not impact the financial statements. Instead, the auditor performs auditing procedures to obtain reasonable assurance that the financial statements do not contain material misstatements, whether due to fraud or error. Thus, the auditor is concerned with detecting fraud that leads to a material misstatement. The auditor is not responsible for detecting fraud that does not lead to a material misstatement.

d. Each entity faces a number of risks unique to the nature of its business and industry. The types of operations, the extent of regulation, how the organization obtains capital to fund its business model, and the nature of accounts in the financial statements, among other factors, each trigger different types of risks that could lead to material misstatements. In addition, there are unique accounting standards for certain industries that impact how transactions, accounts, and disclosures are reported in financial statements. Thus, a thorough understanding of the client's business

e. is critical to assessing the risk of material misstatements in the financial statements when planning the audit.The auditor is responsible for obtaining sufficient appropriate audit evidence about whether the financial statements are free of material misstatements. In addition to understanding whether the amounts reported in the financial statements are mathematically accurate, the auditor obtains other types of information to determine that the amounts reported represent valid transactions and accounts and that all valid transactions and accounts are included in those statements. Evidence is also gathered to determine that the entity has the rights to assets and has the obligation to repay liabilities

2-16 (continued)

reflected in those financial statements and whether the correct disclosures are included in the financial statements as required by accounting standards.

2-17 a. Engagement performance
b. Leadership responsibilities
c. Monitoring
d. Engagement performance
e. Engagement performance
f. Relevant ethical requirement
g. Human resources
h. Human resources
i. Acceptance and continuation of clients and engagements
j. Engagement performance

2-18 a. The AICPA Auditing Standards Board (ASB) is responsible for issuing standards in the U.S. to be used by auditors when auditing the financial statements of all entities other than U.S. publicly traded companies. The Public Company Accounting Oversight Board (PCAOB) is responsible for issuing standards to be used by auditors when auditing a U.S. public company or other entities registered with the SEC (e.g., broker-dealers).

b. The International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) is responsible for issuing International Standards on Auditing (ISAs). The ISAs do not override a specific country's regulations governing the audit of financial statements.

c. The ASB has revised most of its standards to converge them with the international standards. As a result, U.S. standards are mostly consistent with international standards, except for certain requirements that reflect unique characteristics of the U.S. environment.

d. When developing a new SAS, the ASB uses the ISAs as the base standard and then modifies that base standard only when appropriate for the U.S. environment.

e. The PCAOB develops and issues its standards. While the PCAOB considers existing international standards, it does not start with the ISA standard as the base.

f. When conducting an audit of a client that is listed on both a foreign stock exchange and a U.S. stock exchange, the auditor would have to satisfy both the relevant international auditing standards as well as the PCAOB auditing standards. This does not mean the auditor conducts two separate audits, but rather their procedures must satisfy both sets of standards, which will be similar in many ways but may also require the auditor to perform additional procedures required by one, but not the other, set of standards.

2-19
a. AICPA auditing standards.
b. International auditing standards.
c. PCAOB auditing standards.
d. PCAOB auditing standards (reporting in the U.K. will be under international auditing standards).
e. AICPA auditing standards.
f. AICPA auditing standards.
g. PCAOB auditing standards.
h. International auditing standards.

2-20

BRIEF DESCRIPTION OF PRINCIPLE	**HOLMES' ACTIONS RESULTING IN FAILURE TO COMPLY WITH PRINCIPLE**
RESPONSIBILITIES PRINCIPLES	
The auditor must possess the competency and capabilities to perform the audit.	It was inappropriate for Holmes to hire the two students to conduct the audit. The audit must be conducted by persons with proper education and experience in the field of auditing. Although a junior assistant has not completed his formal education, he may help in the conduct of the audit as long as there is proper supervision and review.
The auditor must comply with ethical requirements, which include maintaining independence in mental attitude in all matters relating to the audit.	To satisfy this principle, Holmes must be without bias with respect to the client under audit. Holmes has an obligation for fairness to the owners, management, and creditors who may rely on the report. Because of the financial interest in whether the bank loan is granted to Ray, Holmes is independent in neither fact nor appearance with respect to the assignment undertaken.
The auditor must maintain professional skepticism and exercise professional judgment in the performance of the audit and the preparation of the report.	This principle requires Holmes to perform the audit with due care, which imposes on Holmes and everyone in Holmes' organization a responsibility to observe the principles of performance and reporting. Maintaining professional skepticism and exercising professional judgment require critical review at every level of supervision of the work done and the judgments exercised by those assisting in the audit. Holmes did not review the work or the judgments of the assistants and clearly failed to adhere to this standard.

2-20 (continued)

BRIEF DESCRIPTION OF PRINCIPLE	**HOLMES' ACTIONS RESULTING IN FAILURE TO COMPLY WITH PRINCIPLE**
PERFORMANCE PRINCIPLES	
The auditor must adequately plan the work and must properly supervise any assistants.	This principle recognizes that early appointment of the auditor has advantages for the auditor and the client. Holmes accepted the engagement without considering the availability of competent staff. In addition, Holmes failed to supervise the assistants. The work performed was not adequately planned.
The auditor must identify and assess the risks of material misstatement based on a sufficient understanding of the entity and its environment, including its internal control, to design the nature, timing, and extent of further audit procedures.	Holmes did not obtain an understanding of the entity or its internal control, nor did the assistants obtain such an understanding. There appears to have been no audit at all. The work performed was more an accounting service than it was an auditing service.
The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.	Holmes acquired no evidence that would support the financial statements. Holmes merely checked the mathematical accuracy of the records and summarized the accounts. Standard audit procedures and techniques were not performed.

2-20 (continued)

BRIEF DESCRIPTION OF PRINCIPLE	HOLMES' ACTIONS RESULTING IN FAILURE TO COMPLY WITH PRINCIPLE
REPORTING PRINCIPLES	
The auditor must express an opinion in a written report about whether the financial statements are presented in accordance with the applicable financial reporting framework. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.	Holmes' report made no reference to generally accepted accounting principles. Because Holmes did not conduct a proper audit, the report should state that no opinion can be expressed as to the fair presentation of the financial statements in accordance with generally accepted accounting principles. Although Holmes' report contains an expression of opinion, such opinion is not based on the results of a proper audit. Holmes should disclaim an opinion because he failed to conduct an audit in accordance with auditing standards.
The auditor must assess whether the financial statements are presented in accordance with the financial reporting framework.	Holmes' improper audit would not enable him to determine whether generally accepted accounting principles were consistently applied. Holmes' report should make no reference to the consistent application of accounting principles. Management is primarily responsible for adequate disclosures in the financial statements, but when the statements do not contain adequate disclosures the auditor should make such disclosures in the auditor's report. In this case both the statements and the auditor's report lack adequate disclosures.

2-21 a. The objective of the IAASB is to serve the public interest by setting high-quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. International Standards on Auditing (ISA) are used by auditors in countries that have adopted ISAs as their auditing standards

b. The IAASB follows a due process in setting standards.

- The standards-setting Public Interest Activity Committees (PIAC) identify new projects based on review of international developments and consultation with the Public Interest Oversight Board. PIAC meetings are open to the public and written materials are prepared in English.
- The PIAC is responsible for consulting with the PIAC Consultative Advisory Group (CAG) on the identification and prioritization of projects to be undertaken by the PIAC.
- The project may be assigned to a task force, which considers whether to hold a public forum or roundtable.
- When the Project Task Force is satisfied that it has a proposed draft pronouncement that is ready for exposure, it presents the draft to the PIAC for approval. The PIAC votes on the approval of the exposure draft.
- Draft pronouncements are exposed for a minimum of 90 days.
- The task force considers all comments and whether re-exposure is needed.
- When the Project Task Force is satisfied that it has a proposed final pronouncement ready for approval, it presents the revised content of the exposed standard to the PIAC for approval.
- The PIAC votes on the approval or withdrawal of the pronouncement.

c. The IAASB is committed to transparency. Where practicable, meetings are broadcast over the Internet or recorded. Meeting agendas and minutes are published on the International Federation of Accountants (IFAC) Web site. All exposure drafts are subject to public exposure for a minimum of 90 days. Meetings of the PIAC are open to the public.