

Chapter 2

The CPA Profession

■ Review Questions

2-1 The four major services that CPAs provide are:

1. *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.
2. *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.
3. *Tax services* Tax services include preparation of corporate, individual, and estate returns as well as tax planning assistance.
4. *Management consulting services* These services range from suggestions to improve the client's accounting system to computer installations.

2-2 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.

2-3 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.

2-4 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.

2-5 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 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.

2-6 Statement on Standards for Attestation Engagements was first issued in 1986 and its purposes were to provide a framework for attest engagements and to develop standards for those engagements. In 2001, the Auditing Standards Board issued SSAE 10 in response to the need for more detailed standards for specific types of attestation services. SSAE 10 supersedes the previously issued standards and its main purpose is to improve the usefulness of the attestation standards and provide greater flexibility to practitioners in providing assurance services.

2-7 The PCAOB now has responsibility for establishing auditing standards for public companies, while the Auditing Standards Board (ASB) of the AICPA establishes auditing standards for private companies. The ASB previously had responsibility for establishing auditing standards for both public and private companies. Existing auditing standards were adopted by the PCAOB as interim auditing standards for public company audits.

2-8 *Generally accepted auditing standards* are ten general guidelines to aid auditors in fulfilling their professional responsibilities. These guidelines include three general standards concerned with competence, independence, and due professional care; three standards of field work including planning and supervision, understanding the entity and its environment, including its internal control, and the gathering of sufficient appropriate evidence; and four standards of reporting, which require a statement as to presentation in accordance with generally accepted accounting principles, inconsistency observed in the current period in relation to the preceding period, adequate disclosure, and the expression of an opinion as to the fairness of the presentation of the financial statements.

2-8 (continued)

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.

2-9 Auditors can obtain adequate technical training and proficiency 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.

2-10 For the most part, generally accepted auditing standards 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.

2-11 International Standards on Auditing (ISAs) are issued by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC). ISAs are designed to improve the uniformity of auditing practices and related services throughout the world by issuing pronouncements on a variety of audit and attest functions and promoting their acceptance worldwide. A CPA who conducts an audit in accordance with GAAS may not comply with ISAs because there may be additional ISA requirements that extend beyond GAAS requirements.

2-12 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.

2-13 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.

2-14 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.

2-14 (continued)

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. A CPA firm also gives up some independence of activities when it is reviewed by another CPA firm.

2-15 The two divisions of practice that a CPA firm may belong to are the Center for Public Company Audit Firms (CPCAF) and the Private Companies Practice Section (PCPS). A firm may belong to one section, both sections, or neither. Many of the self-regulatory activities of the CPCAF have been taken over by the PCAOB.

Proponents of this division believe that this will improve the quality of practice by CPA firms and that it will improve self-regulation. Critics state that it establishes two classes of CPAs and implies a lower performance quality for firms that are not members of the Center for Public Company Audit Firms.

■ Multiple Choice Questions From CPA Examinations

2-16 a. (1) b. (2) c. (3) d. (3)

2-17 a. (2) b. (1) c. (2) d. (3)

■ Discussion Questions And Problems

2-18

a. The comments summarize the beliefs of many practitioners about the Sarbanes–Oxley Act and the PCAOB. The arguments against the Act can be summarized as four arguments:

1. Costs of complying with the Act are excessively high, especially the requirement to report on internal control over financial reporting, and will discourage companies from becoming public companies.
2. Relative cost for local audit firms is excessively high.
3. Additional oversight is not needed because sufficient quality controls have already been implemented by most audit firms.
4. Three other things already provide assurance of adequate quality: a competitive economic environment, legal liability, and auditing standards.

To support these comments, it can be argued that the profession has generally functioned well with relatively little controversy and criticism.

2-18 (continued)

The arguments against these comments are primarily as follows:

1. Reporting on the effectiveness of internal control over financial reporting will provide benefits in improved controls, resulting in higher quality financial reporting and reduced losses from fraud.
 2. The increased confidence in financial reporting will increase access to capital and lower the cost of capital by reducing information risk.
 3. Changes in the scope of CPA practices and other threats to audit quality required government regulation.
 4. Regulation of public company audits will not affect most audit firms that do not have public company audit clients.
- b. There is no correct answer to this question. Different people reach different conclusions, depending on the weights put on the various arguments. Time is needed to effectively assess both the costs and benefits of the Act.

- 2-19**
- a. Engagement performance
 - b. Personnel management
 - c. Engagement performance
 - d. Engagement performance
 - e. Independence, integrity, and objectivity
 - f. Monitoring
 - g. Acceptance and continuation of clients and engagements
 - h. Personnel management
 - i. Personnel management

- 2-20**
- a. Rossi and Montgomery's primary ethical consideration is their professional competence to perform all of the audit work for filing with the SEC. In addition, if Rossi and Montgomery have performed bookkeeping services or certain consulting services for Mobile Home, they will not be independent under PCAOB and SEC independence requirements. The firm must also be a registered firm with the PCAOB.
 - b. The filing with the SEC, in addition to normal audited financial statements, will require completion and registration with the SEC of Form S-1 which includes an audited summary of operations for the last five fiscal years as well as many additional schedules and descriptions of the business. Each quarter subsequent to the filing, Form 10-Q must be filed; and within 90 days of the end of each fiscal year Form 10-K must be filed with the SEC.

In addition, Form 8-K must be filed whenever significant events have occurred which are of interest to public investors. These forms must be filed in conformity with Regulation S-X, which requires considerable disclosures in addition to those normally required in audited financial statements.

BRIEF DESCRIPTION OF GAAS	HOLMES' ACTIONS RESULTING IN FAILURE TO COMPLY WITH GAAS
GENERAL STANDARDS	
1. The audit must be performed by a person or persons having adequate technical training and proficiency as an auditor.	1. 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.
2. The auditor must maintain independence in mental attitude in all matters relating to the audit.	2. To satisfy the second general standard, 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.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.	3. This standard requires Holmes to perform the audit with due care, which imposes on Holmes and everyone in Holmes' organization a responsibility to observe the standards of field work and reporting. Exercise of due care requires 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.

2-21 (continued)

BRIEF DESCRIPTION OF GAAS	HOLMES' ACTIONS RESULTING IN FAILURE TO COMPLY WITH GAAS
STANDARDS OF FIELD WORK	
<p>1. The auditor must adequately plan the work and must properly supervise any assistants.</p>	<p>1. This standard 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.</p>
<p>2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.</p>	<p>2. 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.</p>
<p>3. 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.</p>	<p>3. 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.</p>
STANDARDS OF REPORTING	
<p>1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).</p>	<p>1. 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.</p>

2-21 (continued)

BRIEF DESCRIPTION OF GAAS	HOLMES' ACTIONS RESULTING IN FAILURE TO COMPLY WITH GAAS
<p>2. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.</p>	<p>2. 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.</p>
<p>3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.</p>	<p>3. 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.</p>
<p>4. 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.</p>	<p>4. Although the 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 generally accepted auditing standards.</p>

- 2-22** a. CPAs can provide the following information and Web links on their firm Web sites:
- Office locations or affiliations
 - Lines of service the firm provides (audit, tax, management consulting, etc.)
 - Industry specialization information for the firm
 - Online software tools and databases
 - Latest tax law developments applicable to clients
 - Calculators for retirement account decisions
 - Online privacy management software
- b. CPA firms invest their resources to develop sophisticated Web sites largely because of a desire to maintain a client-service approach. Increased competition motivates CPA firms to improve the traditional paths of providing information to their clients. A CPA firm can reach clients more quickly and efficiently with vital information via the firm's Web site than through more traditional forms of communication, such as a monthly or quarterly newsletter. Also, as more clients become sophisticated in the area of technology, they expect their CPA firms to do the same by providing a useful Web site that has links to other helpful tools and resources.
- c. The Internet is a useful tool for a CPA firm's accounting and auditing practice in many ways. A firm's Web site can be used to market the firm's accounting and auditing practice. The Internet also connects the firm's global professional staff, making it easier for staff from all over the world to provide client service on a timely basis without having to be physically present at the client's location. CPAs also use online resources and databases to remain current on emerging business and standards-setting issues. Examples include *Standard and Poor's Net Advantage Database* and *Goldman Sachs Research Database*. These two databases provide extensive industry-specific information and coverage of companies that CPAs use on a subscription basis to stay current on industry developments and to obtain industry data useful for auditing and consulting.

■ **Internet Problem Solution: PCAOB Standing Advisory Group**

2-1 The Sarbanes-Oxley Act created The Public Company Accounting Oversight Board (PCAOB) to establish auditing standards, quality control standards, and ethics standards for auditors of public companies. The PCAOB has convened a group to advise the Board on the establishment of auditing and related professional practice standards. Visit the PCAOB's website [http://www.pcaobus.org/Standards/Standards_Setting.aspx] to learn more and answer the following questions.

1. Who serves on the PCAOB's standing advisory group (SAG)? How often does the group meet?

2-1 (continued)

Answer: The SAG is composed of approximately 30 highly qualified persons representing the auditing profession, public companies, investors and others. The Board also has granted six organizations observer status with speaking rights at all SAG meetings. Those six organizations are the Financial Accounting Standards Board, the Government Accountability Office, the International Auditing and Assurance Standards Board, the Securities and Exchange Commission, the Department of Labor, and the Auditing Standards Board of the American Institute of Certified Public Accountants. The SAG meets in person approximately three times per year and by telephone, as necessary.

2. Review the most recent agenda for the SAG and briefly describe some of the key issues discussed during that meeting.

Answer: While student answers will vary depending upon the availability of various SAG meetings, the most recent meeting at the time of preparation of this material was October 5, 2006. During that meeting the SAG dealt with three overall matters. First, there was a discussion of the Board's standards-setting priority for the coming year. Second, the SAG was asked to consider ways in which to measure the success of the PCAOB in achieving its mission outlined in SOX. Finally, the SAG held a panel discussion about issues facing smaller companies and smaller audit firms.

(Note: Internet problems address current issues using Internet sources. Because Internet sites are subject to change, Internet problems and solutions are subject to change. Current information on Internet problems is available at www.prenhall.com/arens).