Auditing and Assurance Services 16th edition Arens Solutions Manual

SKU: 9780134065823-SOLUTIONS

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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.

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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.

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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.

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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.

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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)

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■ 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

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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.

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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.

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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.

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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.

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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.

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Chapter 2

The CPA Profession

In Chapter 1, students learned about the demand for assurance services and the different types of audits. Chapter 2 describes the CPA profession, and the standards that govern audit performance.

Chapter Opening Vignette — "Good Auditing Includes Good Client Service"

This vignette demonstrates that auditors are expected to provide value-added services to clients. The vignette also challenges preconceived notions about the role of auditors, and illustrates that students will be in a position to assist clients immediately upon entering the profession. We use this as an opportunity to discuss the performance expected of new auditors, and that students need to be familiar with real-world activities by reading such sources as the *Journal of Accountancy* and *The Wall Street Journal*.

Certified Public Accounting Firms and their Activities (page 25, page 26)

Many students will be familiar with the "Big 4" and the activities of these firms, but many will not. Most students will have little knowledge of other CPA firms. In a brief class discussion, we highlight for students:

- The three categories of CPA firms
- The names of the Big 4, plus several major firms in the other categories that recruit at our universities
- Changes occurring in each category of firms

We then ask students for their perceptions about why there have been changes among the Big 4 and National/Regional firms. We use this as an opportunity to discuss the forces affecting the profession. We are careful not to offer opinions about the desirability of these changes, or preferences for one firm or category of firm versus another.

We briefly mention the major activities of the firms (audit and assurance services, taxes, and management consulting and risk advisory services). We also note that management consulting and other advisory services are once again growing in importance at the Big 4, although they are restricted from providing many services to public company audit clients. **Table 2-1** (page 25) is helpful in describing the relative size of firms in each category, and the relative importance of each activity. We encourage students to learn more about the major CPA firms by visiting their web sites.

(See Table 2-1; shown on Slide 2-4)

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Structure of CPA Firms (page 27)

We briefly describe the six organizational structures of CPA firms. We emphasize the use of limited liability corporations and partnerships. We ask students to evaluate the desirability of these organizational forms as a potential new entrant into the profession, from the perspective of a partner, and the perspective of an investor.

We use **Table 2-2** (page 28) to describe the typical positions in a CPA firm, the responsibilities of the position, and how long a person stays in each category. We emphasize that technology has increased the responsibility given new staff, and that advancement is fairly rapid.

(See Table 2-2; shown on Slide 2-9)

Sarbanes–Oxley Act and PCAOB (page 29)

We discuss the origins of the Sarbanes–Oxley Act and the significant changes it has brought to financial reporting and the accounting profession. We then discuss the role of the PCAOB in establishing auditing and quality control standards for registered firms with public company audit clients. We clarify that the PCAOB oversight is limited to public company audits and audits of brokers and dealers registered with the SEC. We also discuss the importance of the PCAOB inspections process.

Securities and Exchange Commission (SEC) (page 30)

The four most important things to explain to students about the SEC are:

1. Role of the SEC in general and as it relates to auditors.
2. What companies are required to report to the SEC.
3. Differences between the AICPA and SEC and relation between the PCAOB and SEC.
4. How the SEC influences auditing.

AICPA (page 31)

We talk briefly of the role of the AICPA, with emphasis on its responsibility for the CPA exam and establishing standards and rules. We briefly explain the role of Statements on Auditing Standards in this section, but discuss in more detail in the following section. We encourage students to consider joining the AICPA as a student affiliate member, which is explained more fully on the AICPA website.

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International and U.S. Auditing Standards (page 32)

We discuss the role of auditing standards and introduce the International Auditing and Assurance Standards Board. We note that globalization has increased the need for uniform international accounting and auditing standards. We discuss how the AICPA Auditing Standards Board (ASB) has revised most of its standards to converge with the international standards and how the PCAOB considers existing international standards as it develops PCAOB standards. The vignette at the top of page 33 provides an overview of the approach the ASB is using to converge their standards with international standards.

We use **Figure 2-1** (page 33) to indicate when international, AICPA (U.S. GAAS), and PCAOB standards apply. Homework problems 2-18 and 2-19 are also useful to cover this concept. We emphasize the similarity of the standards.

(See Figure 2-1; shown on Slide 2-26)

Organization of U.S. Auditing Standards (page 34)

First, we describe the Clarity Project and introduce the Principles that provide the framework for generally accepted auditing standards. We review each of these Principles as described on pages 34 through 37 and briefly mention how each of the Principles in the AICPA auditing standards relate to the ten GAAS standards originally included in the PCAOB interim standards. We also note the PCAOB has now reorganized their standards and the 10 GAAS standards no longer apply. **Figure 2-2** (page 35) provides a summary of the AICPA Principles. Similarly, a summary is provided on **OH-2-1**.

(See Figure 2-2; shown on Slide 2-30)

(See OH-2-1)

In this section, we also distinguish the principles from the standards and discuss the classification of AICPA and PCAOB standards. We note that the ASB Clarity Project has resulted in a new AU-C numbering system for the Codification of Statements on Auditing Standards that aligns the organizational structure of AICPA auditing standards with the structure used for international standards.

Review Questions 2-7 and 2-8 can be helpful for class discussion. Students are told they are required to know the core elements of the Principles, but that they do not need to memorize them word for word. Problem 2-20 is a good one to help students understand the application of the Principles that provide the framework for GAAS to practice.

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Quality Control (page 38)

With the increased emphasis on quality control in the profession, we discuss both quality control and peer review briefly. We emphasize the purposes, benefits, and costs of both. Problem 2-17 is useful for defining the elements of quality control.

Students often have difficulty understanding the relation between quality control and peer review. A useful analogy is to describe peer review as an audit of the firm's quality control system. **Figure 2-3** (page 40) is helpful in describing the relation between audit standards, quality control, peer review, and the AICPA practice and quality centers. We clarify that PCAOB inspections relate to public company audits, and peer review relates to other areas of a firm's assurance practice.

(See Figure 2-3; shown on Slide 2-40)

Summary

After covering Chapters 1 and 2, students have an understanding of the value of audit and assurance services, and some of the factors that affect auditor performance. **Figure 2-4** (page 41) provides a useful summary of these factors, and can be used to introduce the concepts of professional ethics and legal liability covered in Chapters 4 and 5.

(See Figure 2-4; shown on Slide 2-41)

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CHAPTER 2

CROSS-REFERENCE OF LEARNING OBJECTIVES AND PROBLEM MATERIAL

LEARNING OBJECTIVES	CONCEPT CHECKS	REVIEW QUESTIONS	MULTIPLE CHOICE QUESTIONS	DISCUSSION QUESTIONS AND PROBLEMS	CASES
2-1 Describe the nature of CPA firms and what they do.	P. 28, 1	2-1			
2-2 Describe the structure of CPA firms.	P. 28, 2	2-1			
2-3 Understand the role of the Public Company Accounting Oversight Board and the effects of the Sarbanes–Oxley Act on the CPA profession.	P. 38, 1	2-2, 2-5	2-15		
2-4 Summarize the role of the Securities and Exchange Commission in accounting and auditing.		2-3, 2-7	2-15		
2-5 Describe the key functions performed by the AICPA.	P. 38, 2	2-4, 2-5			
2-6 Understand the role of international auditing standards and their relation to U.S. auditing standards.	P. 38, 3	2-5, 2-6	2-15	2-18, 2-19, 2-21	
2-7 Use U.S. auditing standards as a basis for further study.		2-7, 2-8, 2-9	2-13, 2-15	2-16, 2-18, 2-20	
2-8 Identify quality control standards and practices within the accounting profession.		2-1, 2-10, 2-11, 2-12	2-14	2-17	

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AICPA PRINCIPLES UNDERLYING AN AUDIT

Purpose of an Audit • Provide an opinion about the financial statements
Responsibilities • Possess appropriate competence and capabilities • Comply with ethical requirements • Maintain professional skepticism and exercise professional judgment
Performance • Obtain reasonable assurance about whether financial statements are free of material misstatement • Plan work and supervise assistants • Determine and apply materiality level or levels • Identify and assess risks of material misstatement based on understanding of entity and its environment, including internal controls • Obtain sufficient appropriate audit evidence
Reporting • Express opinion on financial statements in a written report • Whether financial statements are presented fairly in accordance with financial reporting framework

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PINNACLE MANUFACTURING - Part IV
Control Risk Matrix – Acquisitions

Transaction-Related Audit Objective Internal Controls*	Recorded acquisitions are for goods and services received (occurrence).	Existing acquisition trans-actions are recorded (complete-ness).	Recorded acquisition transactions are stated at the correct amounts (accuracy).	Recorded acquisition transactions are properly included in the master files, and are properly summarized (posting and summarization).	Acquisition transactions are properly classified (classification).	Acquisition transactions are recorded on the correct dates (timing).
1.						
2.						
3.						
4.						
5.						
6.						
7.						
8.						
9.						
Deficiencies* 1.						
2.						
3.						
Assessed control risk						

* Note: This is a standard form to be used by students. There aren't necessarily 9 controls and 3 deficiencies in the case.

PINNACLE MANUFACTURING - Part IV
Control Matrix – Cash Disbursements

Transaction-Related Audit Objectives Internal Controls*	Recorded cash disbursements are for goods and services actually received (occurrence).	Existing cash disbursement transactions are recorded (complete-ness).	Recorded cash disbursement transactions are stated at the correct amounts (accuracy).	Recorded cash disbursement transactions are properly included in the master file, and are properly summarized (posting and summarization).	Cash disbursement transactions are properly classified (classification).	Cash disbursement transactions are recorded on the correct dates (timing).
1.						
2.						
3.						
4.						
5.						
6.						
7.						
8.						
9.						
Deficiencies* 1.						
2.						
3.						
Assessed control risk*						

* Note: This is a standard form to be used by students. There aren't necessarily 9 controls and 3 deficiencies in the case.

ACL INSTALLATION AND INSTRUCTIONS

INTRODUCTION

ACL is generalized audit software used by auditors to extract and analyze data on client's computerized systems. Generalized audit software is discussed on pages 321 and 389 of the text.

The ACL Problems included in selected chapters (Chapters 7, 8, 10, 12, 14, 15, 16 and 17) are intended to provide you with an introduction to ACL. An in-depth study of its use is beyond the scope of most first auditing courses. The guidance provided in this Appendix is intended only to help you solve the problems in the text.

Downloading ACL

Complete the following steps to access the ACL software:

1. Visit the ACL Academic Network page for Professors at http://info.acl.com/Academic-Network-Program_Professor-Sign-up.html
2. Sign up for the ACL Academic Network.
3. You will receive two emails: the first explains your software entitlement and the second will contain instructions on how to activate the user account and set a password. Access to ACL software expires after six months.
4. More information on the ACL Academic Network for Students can be found here: http://help.aclgrc.com/acl-academic-network-for-students
5. More information about the ACL Academic Network for Professors can be found here: http://help.aclgrc.com/acl-academic-network-for-professors

Note that ACL is only compatible with the following versions of Windows: Windows 10, Windows 8.1, and Windows 7. Additional technical requirements can be found at http://help.aclgrc.com/system-requirements

Opening ACL

An icon to open ACL should be on your desktop after installation. If it does not appear, then go to Windows Start and select "Programs" to then locate the ACL link. Select the ACL link to launch the software.

Finding Companies, Tables, and Using Commands

The main ACL screen should appear when you open the ACL software. Look at that screen now.

On that screen, you will see a choice to create a new analytic project or open an analytic project. Click on the link for "Open Analytic Project." Within the "Sample Files" you will see three projects listed. The ACL assignments in the text use only two of these projects: ACL_Rockwood and ACL_Cypress_Pcards. Both of these projects have several folders and files within those folders, which ACL calls tables. You will first double-click on a project to identify the folders, which will appear in the left side of your screen window once you double-click on the project folder. (***Note:*** When you open ACL again, any projects you have accessed will appear under "Recent Analytics Files" and can be accessed using those links.)

Note: From now on, when you see italics it means you should use your computer to follow an instruction. The arrow sign (→) indicates an additional action to be taken.

> *Double-Click ACL_Rockwood to open the* folders *under ACL_Rockwood → Click the plus sign next to the payroll folder* to view the available tables.

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Observe that there are now three tables available in the payroll folder.

Double click Payroll_details and observe that a typical ACL table labeled Payroll_details for payroll transactions opens. On the bottom row of that screen, the number of records in the table is listed (5,801). The table includes columns with titles and data in each column. That is the information that auditors verify using various commands.

Click the top of the Net pay *column on the table (make sure the column is now all dark)* → *Go to the Windows drop-down options at the top of the screen and select "Analyze" (on the Menu bar)* → *Under "Analyze," select "Total" (on the drop-down list).*

The amount shown on the screen should be 7,466,987.20. You just used an ACL command (Total) to calculate the total of the net pay amounts in the table. That sure beats using a calculator or reentering the data in Excel.

Click the small x below the large X at the top right hand side of your screen to close that window and return to the Payroll_details table.

→ *Click the small x below the large X to close the Payroll_details table. ACL_Rockwood Project" will still be open on the left side of the screen.*
→ *Click the large X to exit ACL.*

You will use the remainder of this material to help you answer the assigned questions in the text. The first three functions (Quick Sort, Filters, and Computed Fields) are not considered ACL commands. The remaining functions included here are all ACL commands. You will use these commands in ACL homework problems that are included in selected chapters. The descriptions below provide a brief overview of the functions that will be used to complete those problems. Within each ACL homework problem in the text, you will see the commands needed to answer the problem listed within parentheses in that problem.

Quick Sort Used to sort data in any field, either from lowest to highest or vice versa.

1. *Click on the column heading of the field you want to sort.*
2. *Right click* on the top of the column *to find the* → *Quick Sort Ascending or Quick Sort Descending.* (You can right click *Quick Sort Off* to undo the sort.)

Filters Used to ask questions of data in a table without adding a new field.

1. *Click the Edit View Filter button* (fx) in the row above the column headings *to enter the Edit view filter window.*
2. *Use the Expression box to build an expression.*
3. The Expression box is where you build filters using the available fields in the current table, as well as the operators (=, < >, AND, etc.). There are three components to a filter: (1) field, (2) operator, and (3) a numeric value, character value, or date.
4. *In the Available Fields portion of the window, double-click the name of the field for which you are building a filter.* Notice that the field name is inserted in the Expression box.
5. *Use the operator buttons (=, +, <, >, etc.) and the numeric keypad on the keyboard to build the filter.* ***Note:*** If you are performing a recalculation to determine if the original calculation already in the data table is correct, use <> as the operator with no spaces between the less than and greater than signs.
6. *Enter an appropriate string or value after the operator. Use the following guidelines:*
   - **Numeric values**—enter as a number with no commas or dollar signs. For example, to enter $1,000, type 1000.

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THE CPA PROFESSION

CHAPTER 2

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CHAPTER 2 LEARNING OBJECTIVES

2-1 Describe the nature of CPA firms and what they do.

2-2 Describe the structure of CPA firms.

2-3 Understand the role of the Public Company Accounting Oversight Board and the effects of the Sarbanes-Oxley Act on the CPA profession.

2-4 Summarize the role of the Securities Exchange Commission in accounting and auditing.

2-5 Describe the key functions performed by the AICPA.

2-6 Understand the role of international auditing standards and their relation to U.S. auditing standards.

2-7 Use U.S. auditing standards as a basis for further study.

2-8 Identify quality control standards and practices within the accounting profession.

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OBJECTIVE 2-1
Describe the nature of CPA firms and what they do.

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TABLE 2-1 Revenue and Other Data for the Largest CPA Firms in the United States

2014 Size by Revenue	Firm	Net Revenue—U.S. Only (in $ millions)	Partners	Professionals	U.S. Offices	Percentage of Total Revenue from Accounting and Auditing/Taxes/Management Consulting and Other
BIG FOUR						
1	Deloitte	$ 14,908.0	3,030	50,562	107	29/18/53
2	PwC	$ 11,724.0	2,691	33,024	72	41/28/31
3	Ernst & Young	$ 9,900.0	2,700	26,100	80	36/29/35
4	KPMG[1]	$ 6,870.0	1,813	20,113	101	34/28/38
NATIONAL/REGIONAL[2]						
5	McGladrey	$ 1,470.7	644	5,075	75	41/36/23
6	Grant Thornton	$ 1,382.5	529	4,692	57	41/28/31
7	BDO	$ 833.0	346	2,967	52	58/32/10
8	Crowe Horwath	$ 686.6	257	2,315	29	28/24/48
9	CBIZ/Mayer Hoffman McCann[3]	$ 600.0	429	1,832	103	30/35/35
10	CliftonLarsonAllen	$ 598.4	225	3,245	29	40/33/27
LOCAL						
50	Frank, Rimerman + Co.	$ 70.2	23	267	5	27/62/11
75	Freed Maxick CPAs	$ 45.5	35	240	4	38/38/24

(1) KPMG's office figure comprises business offices, as opposed to every physical location.
(2) Only the six largest national/regional firms are listed.
(3) Office figures are for CBIZ; MHM has 34 offices.

Source: Data from *Accounting Today* (www.accountingtoday.com).

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ACTIVITIES OF CPA FIRMS

- CPA firms provide audit services as well as other attestation and assurance services.
- CPA firms also provide accounting and bookkeeping services, tax services, and management consulting and risk advisory services.
- Although the Sarbanes-Oxley Act and the SEC restrict auditors from providing many consulting services to public company audit clients, audit firms are not restricted from providing consulting to private companies and public companies that are not audit clients.

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OBJECTIVE 2-2
Describe the structure of CPA firms.

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ORGANIZATIONAL STRUCTURE

CPA firms vary in nature and range of services, which affects the structure of the firms. Three main factors that affect the structure of all firms are:

1. The need for independence from clients
2. The importance of a structure to encourage competence
3. The increased litigation risk faced by auditors

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SIX ORGANIZATIONAL STRUCTURES ARE AVAILABLE TO CPA FIRMS

- Proprietorship
- General Partnership
- General Corporation
- Professional Corporation
- Limited Liability Companies
- Limited Liability Partnership

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ORGANIZATIONAL HIERARCHY OF TYPICAL CPA FIRM

TABLE 2-2 Staff Levels and Responsibilities

Staff Level	Average Experience	Typical Responsibilities
Staff Assistant	0–2 years	Performs most of the detailed audit work.
Senior or in-charge auditor	2–5 years	Coordinates and is responsible for the performance of audit procedures, including supervising and reviewing staff work.
Manager and Senior Manager	5–10 years	Helps the in-charge plan and manage the audit, reviews the in-charge's work, and manages relations with the client. A manager may be responsible for more than one engagement at the same time.
Partner	10+ years	Reviews the overall audit work and is involved in significant audit decisions. A partner is an owner of the firm and therefore has the ultimate responsibility for conducting the audit and serving the client.

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OBJECTIVE 2-3
Understand the role of the Public Company Oversight Board and the effects of the Sarbanes-Oxley Act on the CPA profession.

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SARBANES-OXLEY ACT AND PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

- Sarbanes-Oxley Act—Established the Public Company Accounting Oversight Board (PCAOB).
- PCAOB—Provides oversight for auditors of public companies including:
  - Establishing auditing, attestation, and quality control standards for public company audits.
  - Performing inspections of audit engagements and quality controls.

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OBJECTIVE 2-4
Summarize the role of the Securities Exchange Commission in accounting and auditing.

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SECURITIES AND EXCHANGE COMMISSION

- The Securities Exchange Commission (SEC)—A federal government agency that assists in providing investors with reliable information upon which to make investing decisions.
- The Securities Act of 1933—Requires most companies planning to issue new securities to the public to submit a registration statement to the SEC for approval.

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SECURITIES EXCHANGE COMMISSION (CONT.)

- The Securities Exchange Act of 1934—Provides additional protection for investors by requiring public companies to file detailed annual reports with the commission.
- The Securities Acts of 1933 and 1934—Require financial statements and the opinion of an independent public accountant as part of the registration statement and subsequent reports.

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SECURITIES EXCHANGE COMMISSION (CONT.)

Several reports required by the SEC are of interest to auditors:

- Form S-1—"S" forms must be completed prior to issuing new securities to the public
- Form 8-K—report significant events of interest to investors
- Form 10-K—annual report with detailed financial information, including audited financial statements
- Form 10-Q—quarterly report containing certain financial information and auditor reviews of financial statements

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OBJECTIVE 2-5
Describe the key functions performed by the AICPA.

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

CPAs are licensed by the state in which they practice, but significant influence is exerted by their professional organization, the American Institute of Certified Public Accountants (AICPA).

Membership in the AICPA is restricted to CPAs. Membership is voluntary, so not all CPAs are members, but it is the largest professional association for CPAs in the United States.

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The AICPA sets standards and rules that all members and other practicing CPAs must follow in four major areas:

- Auditing standards
- Compilation and review standards
- Other attestation standards
- Code of Professional Conduct

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Establishing Standards and Rules

- The Auditing Standards Board (ASB) of the AICPA issues auditing standards, called Statements on Auditing Standards (SASs), which apply to all audit engagements not covered by PCAOB standards
- The Accounting and Review Services Committee issues Statements on Standards for Accounting and Review Services (SSARS) that apply to preparation, compilation, and review services
- Statements on Standards for Attestation Engagements apply to assurance on nonfinancial information. Attestation Standards are studied in Chapter 25
- The AICPA Professional Ethics Executive Committee sets rules of conduct that CPAs are required to meet. The Code of Professional Conduct is the subject of Chapter 4

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Other AICPA Functions

- The AICPA writes and grades the CPA Exam.
- The AICPA supports its own research staff and provides grants to others for research.
- The AICPA publishes the *Journal of Accountancy,* industry audit guides, and periodic updates to the Codification of Statements on Auditing Standards and the Code of Professional Conduct.

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OBJECTIVE 2-6
Understand the role of international auditing standards and their relation to U.S. auditing standards.

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INTERNATIONAL AND U.S. AUDITING STANDARDS

- International Standards on Auditing (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).
- IFAC is a worldwide organization for the accountancy profession.
- IAASB works to improve uniformity of auditing practices throughout the world.

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INTERNATIONAL AND U.S. AUDITING STANDARDS (CONT.)

- ISAs do not override a country's regulations governing audit practices.
- Most countries, including the United States, base their auditing standards on ISAs, modified as appropriate for each country's regulatory environment.
- The Auditing Standards Board in the United States has revised its audit standards to converge with international standards.

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AICPA AUDITING STANDARDS

- Auditing standards for private companies and other entities in the United States are established by the Auditing Standards Board (ASB) of the AICPA.
- These standards are called Statements of Auditing Standards (SASs). The AICPA standards are also referred to as generally accepted auditing standards (GAAS).
- Prior to passage of the Sarbanes-Oxley Act, the ASB established auditing standards for private and public companies. Now the PCAOB has responsibility for auditing standards for public companies and brokers and dealers registered with the SEC.

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PCAOB STANDARDS

- Initially, the PCAOB adopted existing auditing standards established by the ASB as interim standards.
- The PCAOB considers international standards when developing new standards.
- PCAOB standards apply only to the audits of U.S. public companies and brokers and dealers registered with the SEC.
- Figure 2-1 shows the relationships among international auditing standards, AICPA auditing standards, and PCAOB auditing standards.

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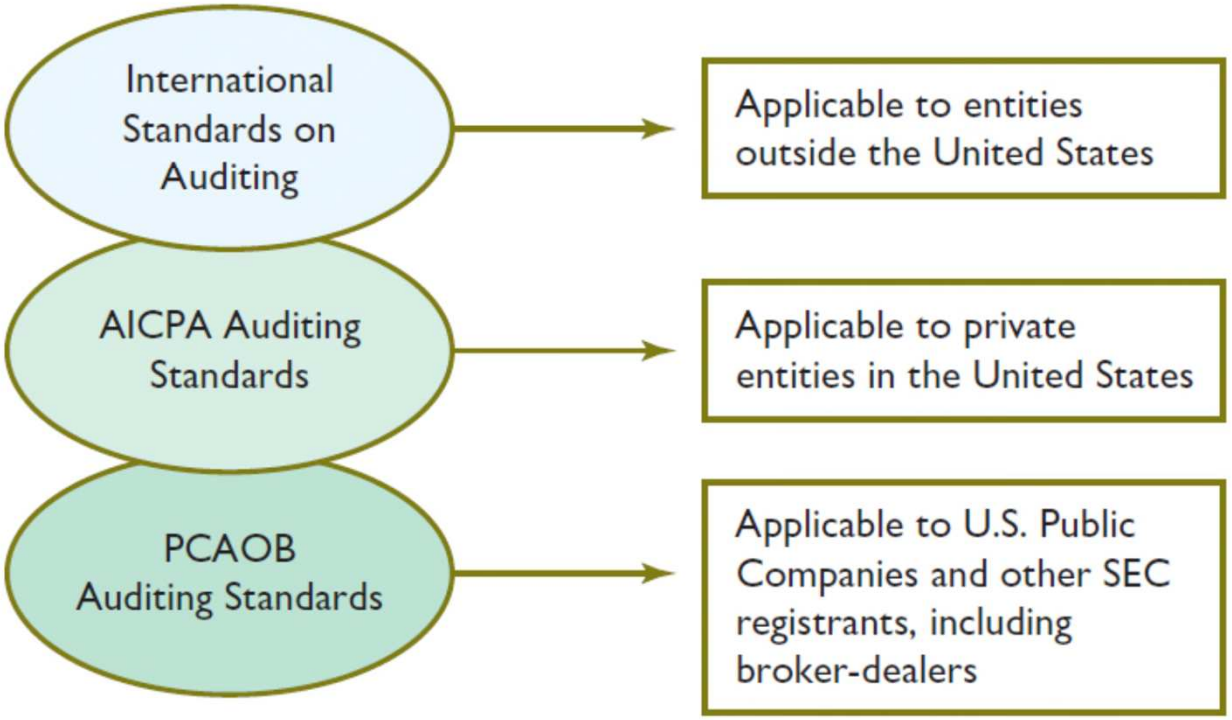
FIGURE 2-1 Relation of U.S. and International Auditing Standards



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OBJECTIVE 2-7
Use U.S. standards as a basis for further study.

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ORGANIZATION OF U.S. AUDITING STANDARDS

- The ASB issued a Preface to the Codification of Auditing Standards containing the "Principles Underlying an Audit in Accordance with Generally Accepted Auditing Standards" (the principles).
- The principles provide a framework for the two objectives of conducting an audit of financial statements:
  1. Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
  2. Report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings.

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ORGANIZATION OF U.S. AUDITING STANDARDS (CONT.)

The principles are not requirements and do not carry authority, but they provide structure for the Codification. The structure is organized around the following principles:

- Purpose of an audit (Purpose)
- Personal responsibilities of the auditor (Responsibilities)
- Auditor actions in performing the audit (Performance)
- Reporting (Reporting)

These principles are summarized in Figure 2-2.

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FIGURE 2-2 AICPA Principles Underlying an Audit

Principles in AICPA Auditing Standards

Purpose of an Audit
- Provide an opinion about the financial statements

Responsibilities
- Possess appropriate competence and capabilities
- Comply with ethical requirements
- Maintain professional skepticism and exercise professional judgment

Performance
- Obtain reasonable assurance about whether financial statements are free of material misstatement
- Plan work and supervise assistants
- Determine and apply materiality level or levels
- Identify and assess risks of material misstatement based on understanding of entity and its environment, including internal controls
- Obtain sufficient appropriate audit evidence

Reporting
- Express opinion on financial statements in a written report
- Whether financial statements were presented fairly in accordance with financial reporting framework

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ORGANIZATION OF U.S. AUDITING STANDARDS (CONT.)

- Purpose: The purpose of an audit is to provide financial statement users with an opinion issued by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with applicable financial reporting framework.
- Responsibilities: The auditor's responsibilities stress the importance of the qualities that the auditor should possess:
  - Appropriate competence and capabilities
  - Comply with relevant ethical requirements
  - Maintain professional skepticism and exercise professional judgment

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ORGANIZATION OF U.S. AUDITING STANDARDS (CONT.)

- Performance: To obtain reasonable assurance that the financial statements are presented fairly, the auditor fulfills several performance responsibilities:
  - Adequate planning and supervision
  - Determine and apply materiality levels
  - Assess risks of material misstatement
  - Sufficient appropriate evidence
- Reporting: The auditor is responsible for expressing an opinion in the form of a written report about whether the financial statements are expressed fairly, in all material respects, in accordance with the applicable financial reporting framework.
- The audit report is the final step in the auditing process.

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ORGANIZATION OF U.S. AUDITING STANDARDS (CONT.)

Principles versus Auditing Standards

The principles underlying auditing standards are general.

The standards (SASs issued by the AICPA and ASs issued by the PCAOB) provide specific guidance.

Classification of Auditing Standards

SASs issued by the AICPA have two classification numbers: an SAS number identifying the order in which it was issued and an AU-C number indicating its location in the Codification of Auditing Standards.

Auditing Standards issued by the PCAOB are also numbered consecutively as issued. The PCAOB recently reorganized their standards by topic.

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ORGANIZATION OF U.S. AUDITING STANDARDS (CONT.)

Standards of Performance

Although auditing standards provide authoritative guidance for members of the profession, the amount of guidance is limited.

The AICPA principles and auditing standards are minimum standards of performance. If standards seem impractical in a certain situation, the auditor may use an alternative course of action, though the burden of justifying a departure from the standards falls on the auditor.

When auditors want more specific guidelines, they must use less authoritative sources. Materials published by the AICPA, including industry audit guides, provide assistance on specific questions.

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OBJECTIVE 2-8
Identify quality control standards and practices within the accounting profession.

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QUALITY CONTROL

For a CPA firm, quality control includes the methods used to ensure that the firm meets its professional responsibilities to clients.

Elements of Quality Control: Each firm should document quality control policies and procedures. The quality control system should address the six elements detailed in Table 2-3.

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TABLE 2-3 Elements of Quality Control

Element	Summary of Requirements	Example of a Procedure
Leadership responsibilities for quality within the firm ("tone at the top")	The firm should promote a culture that quality is essential in performing engagements and should establish policies and procedures that support that culture.	The firm's training programs emphasize the importance of quality work, and this is reinforced in performance evaluation and compensation decisions.
Relevant ethical requirements	All personnel on engagements should maintain independence in mind and in appearance, perform all professional responsibilities with integrity, and maintain objectivity in performing their professional responsibilities.	Each partner and employee must answer an "independence questionnaire" annually, dealing with such things as stock ownership and membership on boards of directors.
Acceptance and continuation of client relationships and specific engagements	Policies and procedures should be established for deciding whether to accept or continue a client relationship or specific engagement. These policies and procedures should minimize the risk of associating with a client whose management lacks integrity. The firm should also only undertake engagements that can be completed with professional competence.	A client evaluation form, dealing with such matters as predecessor auditor comments and evaluation of management, must be prepared for every new client before acceptance.
Human resources	Policies and procedures should be established to provide the firm with reasonable assurance that • All new personnel should be qualified to perform their work competently. • Work is assigned to personnel who have adequate technical training and proficiency. • All personnel should participate in continuing professional education and professional development activities that enable them to fulfill their assigned responsibilities. • Personnel selected for advancement have the qualifications necessary for the fulfillment of their assigned responsibilities.	Each professional must be evaluated on every engagement using the firm's individual engagement evaluation report.
Engagement performance	Policies and procedures should exist to ensure that the work performed by engagement personnel meets applicable professional standards, legal and regulatory requirements, and the firm's standards of quality.	The firm's director of accounting and auditing is available for consultation and must approve all engagements before their completion.
Monitoring	Policies and procedures should exist to ensure that the other quality control elements are being effectively applied.	The quality control partner must test the quality control procedures at least annually to ensure the firm is in compliance.

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QUALITY CONTROL (CONT.)

Peer Review

Public accounting firms must enroll in an AICPA-approved practice-monitoring program, also known as peer review, which is administered by the state CPA societies.

Firms required to be registered with the PCAOB must be reviewed by the AICPA National Peer Review Committee to review the non-SEC portion of the firms practice that is not inspected by the PCAOB.

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QUALITY CONTROL (CONT.)

Audit Practice and Quality Centers

The AICPA has established audit practice and quality centers to improve audit practice quality.

The Center for Audit Quality (CAQ) is a public policy organization affiliated with the AICPA serving investors, public company auditors, and the capital markets.

The Private Companies Practice Section (PCPS) provides practice management information to firms of all sizes.

Figure 2-3 summarizes the relationships among auditing standards, quality control, the audit practice and quality centers, and peer review in ensuring audit quality.

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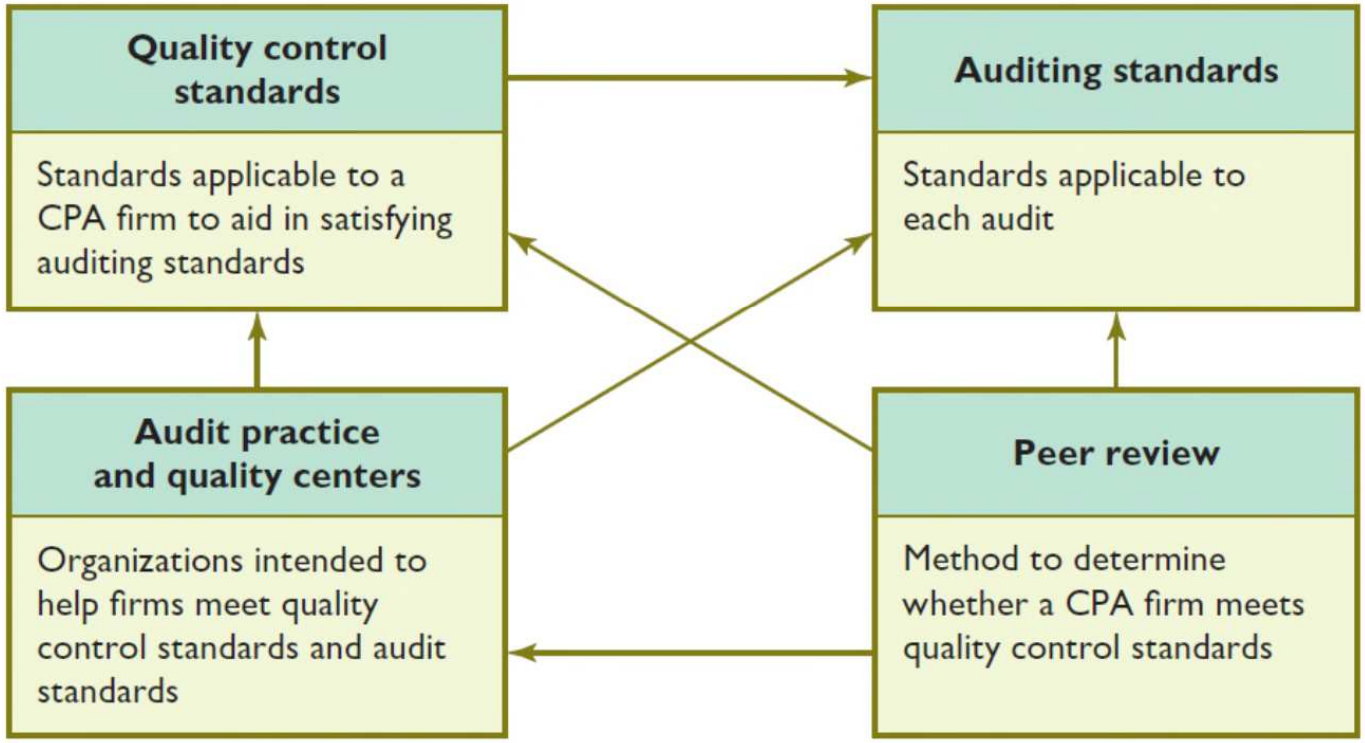
FIGURE 2-3 Relationships Among Auditing Standards, Quality Control, AICPA Practice Centers, and Peer Review



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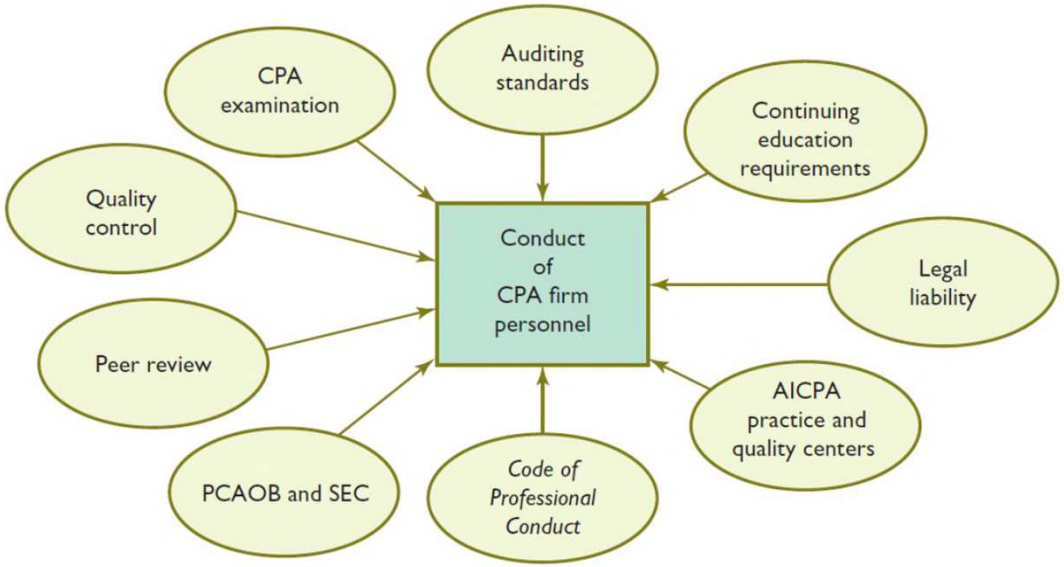
CHAPTER 2 SUMMARY

This chapter discussed the nature of the CPA profession and the need for CPAs to conduct themselves at a high level, which is detailed in Figure 2-4 below.

FIGURE 2-4 **Ways the Profession and Society Encourage CPAs to Conduct Themselves at a High Level**



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