CHAPTER 2

THE AUDIT STANDARDS' SETTING PROCESS

Good Auditing Includes Good Client Service

"It had been a good week," thought Jeanine Wilson, as she drove out of the parking lot of Solberg Paints on Friday afternoon. Just a few months earlier, she graduated from State University and sat for the CPA examination. Still, Jeanine did not think her transition to professional life had been all that smooth, and she was surprised at how much there still was to learn. But she had made great progress on the Solberg engagement.

John Hernandez was the audit senior on the Solberg Paints audit, and he had a reputation as a patient teacher and supervisor. Jeanine was not disappointed. At the start of the engagement, John told her, "Don't be afraid to ask questions. If you see anything that seems unusual, let's discuss it. And most importantly, if you have any ideas that will help the client, bring them up. The client expects us to deliver more than an audit report."

"I'd say I delivered," thought Jeanine. She found an error in the way the company had calculated LIFO inventory that was going to save the client a significant amount of taxes. But her biggest contribution almost did not happen. Jeanine read as much as she could about paint manufacturers and learned about some new production control methods that seemed like they could apply to Solberg. She was afraid to bring it up, thinking that she couldn't possibly know anything that the client didn't already know, but John encouraged her to discuss it with the client. The result was that the client wanted to meet further with Jeanine's firm to better understand how they could improve their production processes.

Friday was the last day of field work on the audit, and the partner, Bill Marlow, was at the client's office to complete his review of the audit files. Jeanine was surprised to hear him say to her, "What are you doing on the 15th? We're going to meet with the client to discuss our audit findings. You've made a real contribution on this audit, and I'd like you to be there." Jeanine tried not to show her excitement too much, but she couldn't hide the smile on her face. "Yes, it had been a good week."

LEARNING OBJECTIVES

After studying this chapter, you should be able to

- **2-1** Describe the nature of CPA firms, what they do, and their structure.
- **2-2** Understand the role of the Public Company Accounting Oversight Board and the effects of the Sarbanes–Oxley Act on the CPA profession.
- **2-3** Summarize the role of the Securities and Exchange Commission in accounting and auditing.
- **2-4** Describe the key functions performed by the AICPA.
- **2-5** Understand the role of international auditing standards and their relation to U.S. auditing standards.
- **2-6** Use U.S. auditing standards as a basis for further study.
- **2-7** Identify quality control standards and practices within the accounting profession.

We learned in the first chapter that auditing plays an important role in society by reducing information risk and facilitating access to capital and that audit firms provide additional, value-added service to their clients. As the opening story to this chapter demonstrates, audit professionals at all experience levels serve as valued advisors to their clients. This chapter describes the organization of CPA firms and the types of services they provide. We also discuss the effects on auditing of the Sarbanes–Oxley Act and the Public Company Accounting Oversight Board (PCAOB), as well as other standards and regulatory agencies that influence auditor performance.

CERTIFIED PUBLIC ACCOUNTING FIRMS

OBJECTIVE 2-1

Describe the nature of CPA firms, what they do, and their structure.

Except for certain governmental organizations, the audits of all general use financial statements in the United States are done by CPA firms. The legal right to perform audits is granted to CPA firms by regulation in each state. CPA firms also provide many other services to their clients, such as tax and advisory services.

It is estimated that more than 45,000 CPA firms exist in the United States. These firms range in size from 1 person to 40,000 partners and staff. Table 2-1 provides revenue and other data for some of the largest accounting firms in the United States. Four size categories are used to describe CPA firms: Big Four international firms, national firms, regional and large local firms, and small local firms.

- *Big Four international firms.* The four largest CPA firms in the United States are called the "Big Four" international CPA firms. They are the first four firms listed in Table 2-1. These four firms have offices throughout the United States and

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

2012 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	$ 11,939.0	2,886	38,301	100	32/20/48
2	PricewaterhouseCoopers	$ 8,844.0	2,290	25,237	73	48/29/23
3	Ernst & Young	$ 7,500.0	2,400	19,400	78	40/31/29
4	KPMG	$ 5,361.0	1,744	15,664	88	43/26/31
NATIONAL						
5	McGladrey(1)	$ 1,370.4	708	4,843	85	43/36/21
6	Grant Thornton	$ 1,146.1	549	4,048	56	45/29/26
7	CBIZ/Mayer Hoffman McCann(2)	$ 597.5	415	1,692	150	23/27/50
8	BDO USA	$ 572.0	260	1,734	41	61/28/11
REGIONAL(3)						
9	Crowe Horwath	$ 529.7	247	1,579	28	45/23/32
10	BKD	$ 391.2	244	1,223	30	50/32/18
11	Moss Adams	$ 323.0	230	1,081	19	51/35/14
12	Plante Moran	$ 304.4	217	975	16	52/32/16
LARGE LOCAL						
50	Habif, Arogeti & Wynne	$ 58.1	29	206	2	45/36/19
75	Berkowitz Dick Pollack & Brant	$ 38.6	17	96	3	20/42/38

(1) RSM McGladrey and McGladrey & Pullen had an alternative practice structure in which each operated as a separate and independent legal entity until November 2011 when McGladrey & Pullen acquired RSM McGladrey. The firm changed its name to McGladrey in May 2012.

(2) CBIZ and Mayer Hoffman McCann are affiliated through an alternative practice structure.

(3) Only the four largest regional firms are listed.

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

throughout the world. The Big Four firms audit nearly all of the largest companies both in the United States and worldwide and many smaller companies as well.

- *National firms.* Four CPA firms in the United States are called national firms because they have offices in most major cities. These are firms 5 through 8 in Table 2-1. These firms are large but considerably smaller than the Big Four. The national firms perform the same services as the Big Four firms and compete directly with them for clients. Each national firm is affiliated with firms in other countries and therefore has an international capability.
- *Regional and large local firms.* There are less than 200 CPA firms with professional staffs of more than 100 people. Some have only one office and serve clients primarily within commuting distances. Others have several offices in a state or region and serve a larger radius of clients. For example, Table 2-1 shows that the largest regional firms are not dramatically smaller than the four national firms. Regional and large local firms compete for clients with other CPA firms, including national and Big Four firms. Many of the regional and large local firms are affiliated with associations of CPA firms to share resources for such things as technical information and continuing education. Many of these firms also have international affiliations.
- *Small local firms.* Most CPA firms have fewer than 25 professionals in a single-office firm. They perform audits and related services primarily for smaller businesses and not-for-profit entities, although some have one or two clients with public ownership. Many small local firms do not perform audits and primarily provide accounting and tax services to their clients.

ACTIVITIES OF CPA FIRMS

As discussed in Chapter 1, CPA firms provide audit services, as well as other attestation and assurance services. Additional services commonly provided by CPA firms include accounting and bookkeeping services, tax services, and management consulting services. CPA firms continue to develop new products and services, such as financial planning, business valuation, forensic accounting, and information technology advisory services.

- *Accounting and bookkeeping services.* Many small clients with limited accounting staff rely on CPA firms to prepare their financial statements. Some small clients lack the personnel or expertise to use accounting software to maintain their own accounting records. Thus, CPA firms perform a variety of accounting and bookkeeping services to meet the needs of these clients. In many cases in which the financial statements are to be given to a third party, a review or even an audit is also performed. When neither of these is done, the financial statements are accompanied by a type of report by the CPA firm called a compilation report, which provides no assurance to third parties. As Table 2-1 shows, attestation services and accounting and bookkeeping services are the major source of revenue for most large CPA firms.
- *Tax services.* CPA firms prepare corporate and individual tax returns for both audit and nonaudit clients. Almost every CPA firm performs tax services, which may include estate tax, gift tax, tax planning, and other aspects of tax services. For many small firms, such services are far more important to their practice than auditing, as most of their revenue may be generated from tax services.
- *Management consulting services.* Most CPA firms provide certain services that enable their clients to operate their businesses more effectively. These services are called management consulting or management advisory services. These services range from simple suggestions for improving the client's accounting system to advice in risk management, information technology and e-commerce

PEER REVIEW EXPANDS AFTER MADOFF SCANDAL

The AICPA created a voluntary uniform peer review program in 1977 with the establishment of the Division for CPA Firms. Firms were required to be peer reviewed every three years to make certain all firms conducting attest functions adhered to generally accepted auditing standards. In 1988, AICPA members approved mandatory peer reviews for all members. However, since membership in the AICPA is voluntary, firms that were not members were not subject to peer review unless required by the state in which the firm practiced.

Interest in peer review seemed to diminish when PCAOB quality inspections replaced peer review for auditors of public companies. However, the Ponzi scheme involving Bernie Madoff refocused attention on peer review when it was revealed that his sole practitioner auditor was not peer reviewed. In response, New York passed a peer review requirement for all CPA firms in New York State, increasing to 45 the number of states with a peer review requirement. When the New York requirement became effective in January 2012, the number of CPA firms in New York subject to peer review nearly doubled, from approximately 1,800 to about 3,000. Ironically, Madoff's auditor would not have been required to have a peer review under the new requirements, as firms with one or two practitioners are exempt from the requirement.

Sources: Adapted from 1. Richard Stolz, "Peer Review in Need of Review?" (April 20, 2009) (www.webcpa.com); 2. Robert Bunting, "Transparency, the New Peer Review Watchword," *The CPA Journal* (October 2004) p. 6.

system design, mergers and acquisitions due diligence, business valuations, and actuarial benefit consulting. Many large CPA firms have departments involved exclusively in management consulting services with little interaction with the audit or tax staff.

Although the Sarbanes–Oxley Act and Securities and Exchange Commission (SEC) restrict auditors from providing many consulting services to public company audit clients, some services are allowed, and audit firms are not restricted from providing consulting to private companies and public companies that are not audit clients. Table 2-1 (p. 46) shows that management consulting and other services are a significant source of revenue for most accounting firms.

STRUCTURE OF CPA FIRMS

CPA firms vary in the nature and range of services offered, which affects the organization and structure of the firms. Three main factors influence the organizational structure of all firms:

1. *The need for independence from clients.* Independence permits auditors to remain unbiased in drawing conclusions about the financial statements.
2. *The importance of a structure to encourage competence.* Competence permits auditors to conduct audits and perform other services efficiently and effectively.
3. *The increased litigation risk faced by auditors.* Audit firms continue to experience increases in litigation-related costs. Some organizational structures afford a degree of protection to individual firm members.

Organizational Structures

Six organizational structures are available to CPA firms. Except for the proprietorship, each structure results in an entity separate from the CPA personally, which helps promote auditor independence. The last four organizational structures provide some protection from litigation loss.

Proprietorship Only firms with one owner can operate in this form. Traditionally, all one-owner firms were organized as proprietorships, but most have changed to organizational forms with more limited liability because of litigation risks.

General Partnership This form of organization is the same as a proprietorship, except that it applies to multiple owners. This organizational structure has also become less popular as other forms of ownership that offer some legal liability protection became authorized under state laws.

General Corporation The advantage of a corporation is that shareholders are liable only to the extent of their investment in the corporation. Most CPA firms do not organize as general corporations because they are prohibited by law from doing so in most states.

Professional Corporation A professional corporation (PC) provides professional services and is owned by one or more shareholders. PC laws in some states offer personal liability protection similar to that of general corporations, whereas the protection in other states is minimal. This variation makes it difficult for a CPA firm with clients in different states to operate as a PC.

Limited Liability Company A limited liability company (LLC) combines the most favorable attributes of a general corporation and a general partnership. An LLC is typically structured and taxed like a general partnership, but its owners have limited personal liability similar to that of a general corporation. All of the states have LLC laws, and most also allow accounting firms to operate as LLCs.

Limited Liability Partnership A limited liability partnership (LLP) is owned by one or more partners. It is structured and taxed like a general partnership, but the personal liability protection of an LLP is less than that of a general corporation or an LLC. Partners of an LLP are personally liable for the partnership's debts and obligations, their own acts, and acts of others under their supervision. Partners are not personally liable for liabilities arising from negligent acts of other partners and employees not under their supervision. It is not surprising that all of the Big Four firms and many smaller firms now operate as LLPs.

Hierarchy of a Typical CPA Firm

The organizational hierarchy in a typical CPA firm includes partners or shareholders, managers, supervisors, seniors or in-charge auditors, and assistants. A new employee usually starts as an assistant and spends 2 or 3 years in each classification before achieving partner status. The titles of the positions vary from firm to firm, but the structure is similar in all. When we refer in this text to the auditor, we mean the person performing some aspect of an audit. It is common to have one or more auditors from each level on larger engagements.

Table 2-2 summarizes the experience and responsibilities of each classification level within CPA firms. Advancement in CPA firms is fairly rapid, with evolving duties and responsibilities. In addition, audit staff members usually gain diversity of experience across client engagements. Because of advances in computer and audit technology, beginning assistants on the audit are rapidly given greater responsibility and challenges.

The hierarchical nature of CPA firms helps promote competence. Individuals at each level of the audit supervise and review the work of others at the level just below them in the organizational structure. A new staff assistant is supervised directly by the senior or in-charge auditor. The staff assistant's work is then reviewed by the in-charge as well as by the manager and partner.

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 audit field work, including supervising and reviewing staff work.
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.

SARBANES–OXLEY ACT AND PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

OBJECTIVE 2-2

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

Triggered by the bankruptcies and alleged audit failures involving such companies as Enron and WorldCom, the Sarbanes–Oxley Act is considered by many to be the most important legislation affecting the auditing profession since the 1933 and 1934 Securities Acts. The provisions of the Act dramatically changed the relationship between publicly held companies and their audit firms.

The Sarbanes–Oxley Act established the **Public Company Accounting Oversight Board (PCAOB)**, appointed and overseen by the SEC. The PCAOB provides oversight for auditors of public companies, establishes auditing and quality control standards for public company audits, and performs inspections of the quality controls at audit firms performing those audits.

The PCAOB conducts inspections of registered accounting firms to assess their compliance with the rules of the PCAOB and SEC, professional standards, and each firm's own quality control policies. The PCAOB requires annual inspections of accounting firms that audit more than 100 issuers and inspections of other registered firms at least once every three years. Any violations could result in disciplinary action by the PCAOB and be reported to the SEC and state accountancy boards.

SECURITIES AND EXCHANGE COMMISSION

OBJECTIVE 2-3

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

The **Securities and Exchange Commission (SEC)**, an agency of the federal government, assists in providing investors with reliable information upon which to make investment 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. The Securities Exchange Act of 1934 provides additional protection by requiring public companies and others to file detailed annual reports with the commission. The commission examines these statements for completeness and adequacy before permitting the company to sell its securities through the securities exchanges.

Although the SEC requires considerable information that is not of direct interest to CPAs, the securities acts of 1933 and 1934 require financial statements, accompanied by the opinion of an independent public accountant, as part of a registration statement and subsequent reports.

Of special interest to auditors are several specific reports that are subject to the reporting provisions of the securities acts. The most important of these are as follows:

- *Form S-1.* "S" forms apply to the Securities Act of 1933 and must be completed and registered with the SEC when a company plans to issue new securities to the public. The S-1 form is the general form used when there is no specifically prescribed form. The others are specialized forms. For example, S-11 is for registration of securities of certain real estate companies.
- *Form 8-K.* This report is filed to report significant events that are of interest to public investors. Such events include the acquisition or sale of a subsidiary, a change in officers or directors, an addition of a new product line, or a change in auditors.
- *Form 10-K.* This report must be filed annually within 60 to 90 days after the close of each fiscal year, depending on the size of the company. Extensive detailed financial information, including audited financial statements, is contained in this report.
- *Form 10-Q.* This report must be filed quarterly for all publicly held companies. It contains certain financial information and requires auditor reviews of the financial statements before filing with the commission.

Because large CPA firms usually have clients that must file one or more of these reports each year, and the rules and regulations affecting filings with the SEC are extremely complex, most CPA firms have specialists who spend a large portion of their time ensuring that their clients satisfy all SEC requirements.

The SEC has considerable influence in setting generally accepted accounting principles (GAAP) and disclosure requirements for financial statements as a result of its authority for specifying reporting requirements considered necessary for fair disclosure to investors, such as the recent requirement to begin filing financial statement data in XBRL format. The SEC has power to establish rules for any CPA associated with audited financial statements submitted to the commission. The attitude of the SEC is generally considered in any major change proposed by the Financial Accounting Standards Board (FASB), the independent organization that establishes U.S. GAAP.

The SEC requirements of greatest interest to CPAs are set forth in the commission's Regulation S-X, Accounting Series Releases, and Accounting and Auditing Enforcement Releases. These publications constitute important regulations, as well as decisions and opinions on accounting and auditing issues affecting any CPA dealing with publicly held companies.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)

OBJECTIVE 2-4

Describe the key functions performed by the AICPA.

CPAs are licensed by the state in which they practice, but a significant influence on CPAs is exerted by their national professional organization, the **American Institute of Certified Public Accountants (AICPA)**. Membership in the AICPA is restricted to CPAs, but not all members are practicing as independent auditors. Many members formerly worked for CPA firms but are currently working in government, industry, and education. AICPA membership is voluntary, so not all CPAs join. With over 375,000 CPAs, the AICPA is the largest professional association for CPAs in the United States.

The AICPA sets professional requirements for CPAs, conducts research, and publishes materials on many different subjects related to accounting, auditing, attestation and assurance services, management consulting services, and taxes. The AICPA also promotes the accounting profession through organizing national advertising campaigns, promoting new assurance services, and developing specialist certifications to help market and ensure the quality of services in specialized practice areas. For example, the association currently offers specialty designations in business valuation, financial planning, information technology, and financial forensics.

Establishing Standards and Rules

The AICPA sets standards and rules that all members and other practicing CPAs must follow. Four major areas in which the AICPA has authority to set standards and make rules are as follows:

1. *Auditing standards.* The Auditing Standards Board (ASB) is responsible for issuing pronouncements on auditing matters in the U.S. for all entities other than publicly traded companies. ASB pronouncements are called **Statements on Auditing Standards (SASs)**. They are further discussed later in this chapter and throughout the text.
2. *Compilation and review standards.* The Accounting and Review Services Committee is responsible for issuing pronouncements of the CPA's responsibilities when a CPA is associated with financial statements of privately owned companies that are not audited. They are called Statements on Standards for Accounting and Review Services (SSARS), and they provide guidance for performing compilation and review services. In a compilation service, the accountant helps the client prepare financial statements without providing any assurance. In a review service, the accountant performs inquiry and analytical procedures that provide a reasonable basis for expressing limited assurance on the financial statements.

3. *Other attestation standards.* Statements on Standards for Attestation Engagements provide a framework for the development of standards for attestation engagements. Detailed standards have been developed for specific types of attestation services, such as reports on prospective financial information in forecasts and projections. Attestation standards are studied in Chapter 25.
4. *Code of Professional Conduct.* The AICPA Professional Ethics Executive Committee sets rules of conduct that CPAs are required to meet. The rules and their relationships to ethical conduct are the subject of Chapter 5.

Other AICPA Functions

In addition to writing and grading the CPA examination, the AICPA performs many educational and other functions for CPAs. The association supports research by its own research staff and provides grants to others. It also publishes a variety of materials, including journals such as the *Journal of Accountancy*, industry audit guides for several industries, periodic updates of the *Codification of Statements on Auditing Standards*, and the *Code of Professional Conduct.*

CPAs must meet continuing education requirements to maintain their licenses to practice and to stay current on the extensive and ever-changing body of knowledge in accounting, auditing, attestation and assurance services, management consulting services, and taxes. The AICPA provides a considerable number of seminars and educational aids in a variety of subjects, such as online continuing education opportunities and reference materials in its *CPExpress* online learning library and its daily email alert about emerging professional issues through its *CPA Letter Daily*.

INTERNATIONAL AND U.S. AUDITING STANDARDS

OBJECTIVE 2-5

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

Auditing standards are general guidelines to aid auditors in fulfilling their professional responsibilities in the audit of historical financial statements. They include consideration of professional qualities such as competence and independence, reporting requirements, and evidence. The three main sets of auditing standards are International Standards on Auditing, U.S. Generally Accepted Auditing Standards (AICPA auditing standards) for entities other than public companies, and PCAOB Auditing Standards.

International Standards on Auditing

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 the worldwide organization for the accountancy profession, with 167 member organizations in 127 countries, representing more than 2.5 million accountants throughout the world. The IAASB works 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 by promoting their acceptance worldwide.

ISAs do not override a country's regulations governing the audit of financial or other information, as each country's own regulations generally govern audit practices. These regulations may be either government statutes or statements issued by regulatory or professional bodies, such as the Australian Auditing & Assurance Standards Board or Spain's Instituto de Contabilidad y Auditoría de Cuentas. Most countries, including the United States, base their auditing standards on ISAs, modified as appropriate for each country's regulatory environment and statutory requirements.

The Auditing Standards Board in the U.S. has revised most of its standards to converge with the international standards. In addition, the PCAOB considers existing international standards in developing its 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, such as legal and regulatory requirements. For example, PCAOB Standard 5 (AS 5) addresses audits of internal control over financial reporting required by the Sarbanes–Oxley Act.

CONVERGENCE AND CLARITY PROJECT COMPLETION IMPACTS AUDITING STANDARDS

CPAs in the U.S. need to be familiar with international standards on auditing and attest services (ISAs) as these standards become accepted worldwide and are more common in cross-border operations and financing. To address this need, the AICPA Auditing Standards Board (ASB) embarked on its Clarity Project to redraft most of the existing AICPA auditing standards to align them with the ISAs and to make them easier to read, understand, and apply. The ASB is in the final stages of completing this project.

The ASB concluded that it should move its standard-setting process to be more formally aligned with international standards on auditing and the international standard-setting process. The ASB redrafted existing AICPA auditing standards to align them with the respective ISAs and in the future will develop new SASs in conjunction with the IAASB as it develops new ISAs. When developing a new AICPA auditing standard, the ASB uses the new ISA as the base standard and modifies that base when appropriate for the U.S. environment.

Simultaneously with the move toward international convergence, the ASB launched its Clarity Project to make U.S. auditing standards easier to read, understand, and apply. As the ASB redrafted existing guidance, each modified new SAS now:

- Briefly introduces the standard and its context within the audit of financial statements;
- Establishes objectives for each of the standards and aligns those objectives with the overall objective of an audit of financial statements and the overall objective of the auditor in conducting the audit;
- Includes a definition section, where relevant, in each standard;
- Separates requirements from applications or other explanatory material;
- Uses formatting techniques, such as bulleted lists, to enhance readability; and
- Includes special considerations in the audits of smaller, less complex entities and governmental audits.

The effective date for the redrafted standards is for audits of financial statements for periods ending on or after December 15, 2012.

Sources: 1. "Financial Reporting Whitepaper: The AICPA's Guide to Clarified and Converged Standards for Auditing and Quality Control" (www.aicpa.org); 2. "Clarity Project: Update and Final Product" (www.aicpa.org).

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 referred to as Statements on Auditing Standards (SASs). Because the ASB has harmonized its agenda with the IAASB, the AICPA auditing standards are similar to the ISAs, although there are some differences. When developing a new SAS, the ASB uses the ISA as the base standard and then modifies that base standard only when modifications are appropriate for the U.S. environment. If an auditor in the United States is auditing historical financial statements in accordance with ISAs, the auditor must meet any ISA requirements that extend beyond the requirements in the AICPA standards.

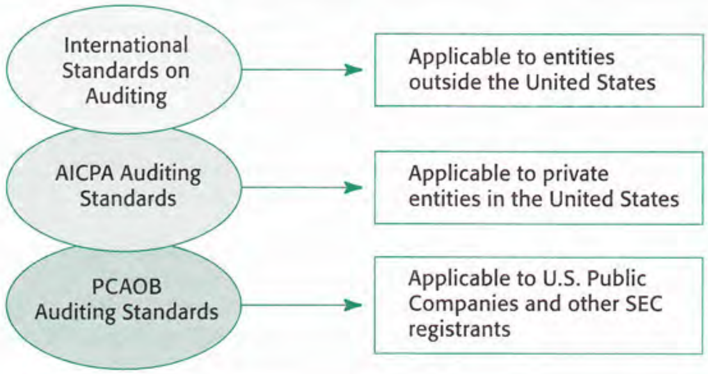
Prior to passage of the Sarbanes–Oxley Act, the ASB established auditing standards in the U.S. for private and public companies. The PCAOB now has responsibility for auditing standards for U.S. public companies, while the ASB continues to provide auditing standards for private companies and other entities. The AICPA auditing standards are also referred to as U.S. generally accepted auditing standards (GAAS).

PCAOB Auditing Standards

The PCAOB initially adopted existing auditing standards established by the ASB as interim audit standards. In addition, the PCAOB considers international auditing standards when developing new standards. As a result, auditing standards for U.S. public and private companies are mostly similar. Standards issued by the PCAOB are referred to as PCAOB Auditing Standards in the audit reports of public companies and when referenced in this text, and apply only to the audits of U.S. public companies.

Figure 2-1 (p. 54) summarizes the relations among international auditing standards, AICPA auditing standards, and PCAOB auditing standards. International auditing standards as adopted by standard-setting bodies in individual countries apply to audits of entities outside the United States. AICPA auditing standards are similar to international auditing standards and apply to the audits of private companies and other entities in the United States. PCAOB auditing standards apply to audits of U.S. public companies and other SEC registrants.

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



The overlapping ovals illustrate that there are more similarities than differences in the three sets of standards. The auditing concepts illustrated throughout this book are generally applicable to all audits. When we refer to "auditing standards," the term applies to all audits unless otherwise noted.

GENERALLY ACCEPTED AUDITING STANDARDS

OBJECTIVE 2-6

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

Historically, auditing standards have been organized along 10 generally accepted auditing standards (GAAS) that fall into three categories:

- General standards
- Standards of field work
- Reporting standards

As part of its Clarity Project, the ASB issued a new Preface to the Codification of Auditing Standards which contains the "Principles Underlying an Audit in Accordance with Generally Accepted Auditing Standards" (referred to as the principles). The **principles** provide a framework to help auditors fulfill the following two objectives when 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, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and
2. Report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings.

While the principles are not requirements and do not carry any authority, they will be used going forward as the framework to provide the structure for the clarified Codification. This 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)

As a result, the 10 GAAS standards will no longer provide the organizational structure of the AICPA auditing standards even though the underlying substance of the 10 GAAS standards continues to be relevant and applicable. Instead, the new principles will provide the framework for the Codification going forward. However,

TABLE 2-3	Generally Accepted Auditing Standards–PCAOB Interim Standards
General Standards	
1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor. 2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors. 3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.	
Standards of Field Work	
1. The work is to be adequately planned and assistants, if any, are to be properly supervised. 2. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed. 3. Sufficient appropriate evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.	
Standards of Reporting	
1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP). 2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period. 3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report. 4. The report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.	

the PCAOB standards are based on the 10 GAAS standards, which are shown in Table 2-3. Because the 10 GAAS standards are relevant to the PCAOB standards and because their substance continues to be relevant to AICPA auditing standards, we refer to them periodically throughout this text as the 10 GAAS standards. Figure 2-2 (p. 56) illustrates the relationship between the principles and the 10 GAAS standards.

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 the applicable financial reporting framework. That opinion enhances the users' degree of confidence they can place in the information presented in the financial statements.

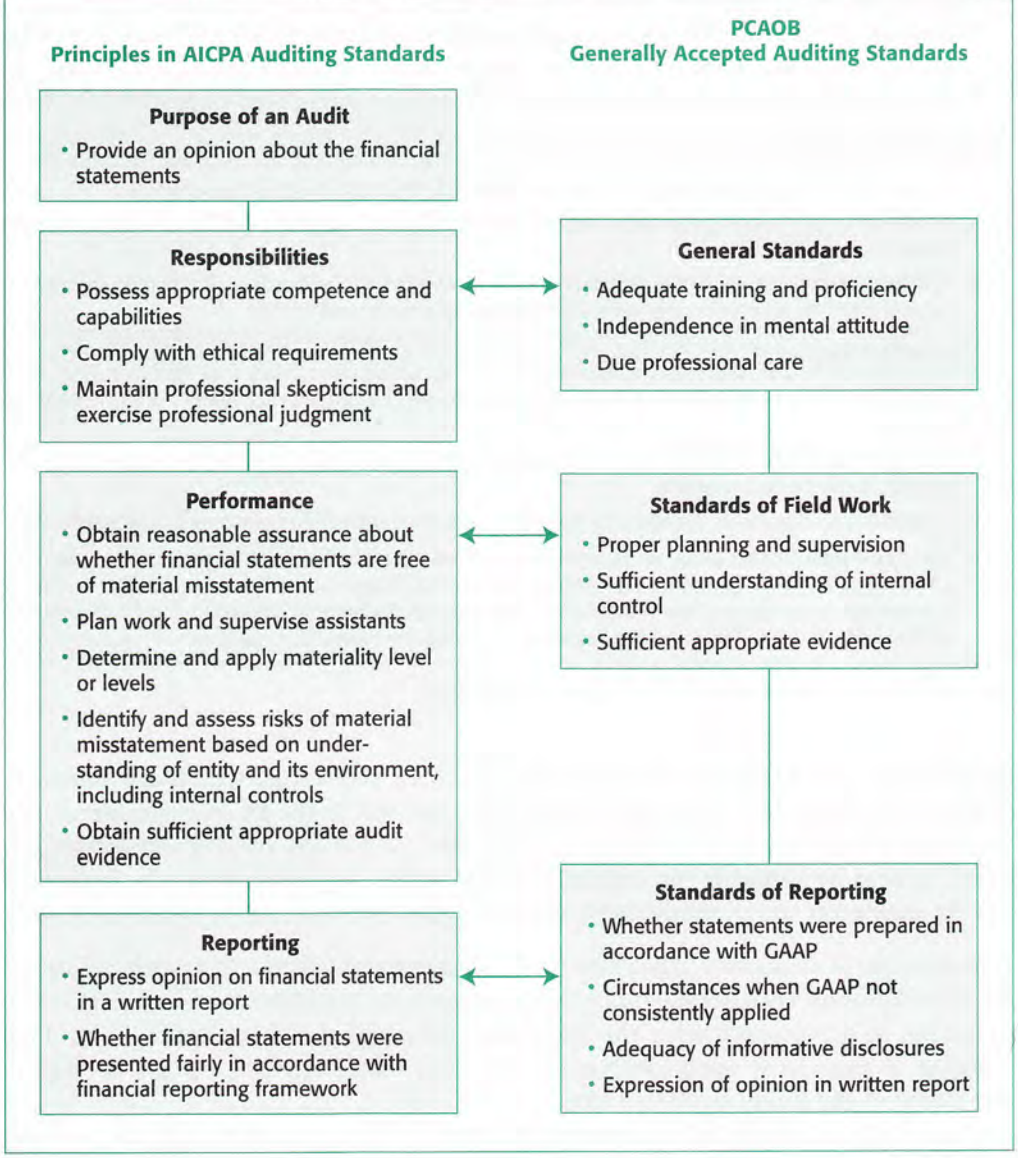
An audit is conducted based on the premise that management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework selected by management and that management has designed, implemented, and maintained internal control relevant to the preparation and presentation of financial statements that are free of material misstatements. An auditor also presumes that management will provide the auditor access to all information relevant to the preparation and presentation of financial statements, including unrestricted access to persons within the entity from whom the auditor may obtain audit evidence.

Responsibilities

Principles related to the auditor's responsibilities in the audit stress important personal qualities that the auditor should possess.

Appropriate Competence and Capabilities Auditors are responsible for having appropriate competence and capabilities to perform the audit. This is normally interpreted as requiring the auditor to have formal education in auditing and accounting, adequate practical experience for the work being performed, and continuing professional education. Recent court cases clearly demonstrate that auditors must be technically qualified and experienced in those industries in which their clients are engaged.

FIGURE 2-2 **Linkage of AICPA Principles Underlying an Audit to PCAOB Generally Accepted Auditing Standards**



In any case in which the CPA or the CPA's assistants are not qualified to perform the work, a professional obligation exists to acquire the requisite knowledge and skills, suggest someone else who is qualified to perform the work, or decline the engagement.

Comply with Relevant Ethical Requirements The AICPA *Code of Professional Conduct* outlines the ethical requirements for CPAs who practice in accounting firms or work in organizations as part of management. The Code and auditing standards stress the need for independence in an audit engagement. Of particular importance are requirements for CPA firms to follow several practices to increase the likelihood of independence of all personnel. For example, there are established procedures on larger audits when there is a dispute between management and the auditors. Specific methods to ensure that auditors maintain their independence and comply with other relevant ethical requirements are studied in Chapter 5.

Maintain Professional Skepticism and Exercise Professional Judgment Auditors are responsible for maintaining professional skepticism and exercising professional judgment throughout the planning and performance of the audit. Auditing standards describe professional skepticism as an attitude that includes a questioning mind, being alert to conditions that might indicate possible misstatements due to fraud or error, and a critical assessment of audit evidence. Simply stated, auditors are to remain alert for the possibility of the presence of material misstatements whether due to fraud or error throughout the planning and performance of an audit.

In making judgments about the presence of material misstatements, auditors are responsible for applying relevant training, knowledge, and experience in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement. Auditors are responsible for fulfilling their duties diligently and carefully.

Performance

Responsibilities related to the performance of the audit relate to auditor actions concerning evidence accumulation and other activities during the actual conduct of the audit. To express an opinion on the financial statements, the auditor obtains reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. To obtain reasonable assurance, the auditor fulfills several performance responsibilities.

Adequate Planning and Supervision The auditor is responsible for sufficiently planning an audit to ensure an adequate audit and proper supervision of assistants. Supervision is essential in auditing because a considerable portion of the audit is done by less experienced staff members.

Determine and Apply Materiality Levels Because the auditor's opinion is about whether the financial statements contain material misstatements, the auditor is responsible for determining and applying an appropriate materiality level or levels throughout the audit. A misstatement is considered material if knowledge of the misstatement will affect a decision of a reasonable user of the financial statements. Chapters 3 and 9 discuss how auditors determine and apply materiality levels.

Assess Risks of Material Misstatement To adequately perform the audit, the auditor is responsible for assessing the risks that the financial statements contain material misstatements and then performing further audit procedures in response to those risks to determine if material misstatements exist. To adequately assess the risk of material misstatements, the auditor must have an understanding of the client's business and industry. This understanding helps the auditor identify significant client business risks and the risk of significant misstatements in the financial statements. For example, to audit a bank, an auditor must understand the nature of the bank's operations, federal and state regulations applicable to banks, and risks affecting significant accounts such as loan loss reserves.

One of the most widely accepted concepts in the theory and practice of auditing is the importance of the client's system of internal control for mitigating client business risks, safeguarding assets and records, and generating reliable financial information. If the auditor is convinced that the client has an excellent system of internal control, one that includes adequate internal controls for providing reliable data, the amount of audit evidence to be accumulated can be significantly less than when controls are not adequate. In some instances, internal control may be so inadequate as to preclude conducting an effective audit.

Sufficient Appropriate Evidence The auditor is responsible for obtaining sufficient appropriate audit evidence about whether material misstatements exist through designing and implementing appropriate responses to the assessed risks. Decisions about how much and what types of evidence to accumulate for a given set of circumstances require professional judgment. A major portion of this book is concerned with the study of evidence accumulation and the circumstances affecting the amount and types needed.

Reporting

The principles related to reporting note that the auditor is responsible for expressing an opinion in the form of a written report about whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. This opinion is based on the evaluation of audit evidence obtained and the auditor's findings. If an opinion cannot be expressed, the auditor's report should state that conclusion.

STATEMENTS ON AUDITING STANDARDS

The principles underlying AICPA standards are too general to provide meaningful guidance, so auditors turn to the SASs issued by the ASB for more specific guidance. Collectively, these statements constitute **generally accepted auditing standards (GAAS)** and are often referred to as auditing standards, SASs, or GAAS. This book follows common practice and refers to these interpretations as auditing standards or SASs. Statements on auditing standards are regarded as *authoritative* literature, and every member who performs audits of historical financial statements is required to follow them under the AICPA *Code of Professional Conduct.* The ASB issues new statements when an auditing problem arises of sufficient importance to warrant an official interpretation. At this writing, SAS 125 was the last one issued and incorporated into the text materials, but readers should be alert to subsequent standards that influence auditing requirements.

Classification of Statements on Auditing Standards

All SASs are given two classification numbers: an SAS and an AU-C number that indicates its location in the *Codification of Auditing Standards.* Both classification systems are used in practice. For example, the Statement on Auditing Standards, *Alert That Restricts the Use of the Auditor's Written Communication*, is SAS No. 125 and AU-C 905. The SAS number identifies the order in which it was issued in relation to other SASs; the AU-C number identifies its location in the AICPA Codification of all SASs. The AU-C section numbering is equivalent to the ISA numbers. The AU-C section numbering is a temporary identifier to avoid confusion with the former AU sections used historically by the ASB. The AU-C identifier will revert to AU in 2014, by which time all the redrafted standards become fully effective for all engagements.

Standards of Performance

Although the SASs are the authoritative auditing guidelines for members of the profession, they provide less direction to auditors than might be assumed. A limited number of specific audit procedures are required by the standards, and there are no specific requirements for auditors' decisions, such as determining sample size, selecting sample items from the population for testing, or evaluating results. Many practitioners believe that the standards should provide more clearly defined guidelines for determining the extent of evidence to be accumulated. Such specificity would eliminate some difficult audit decisions and provide a line of defense for a CPA firm charged with conducting an inadequate audit. However, highly specific requirements could turn auditing into mechanistic evidence gathering, devoid of professional judgment. From the point of view of both the profession and the users of auditing services, there is probably greater harm in defining authoritative guidelines too specifically than too broadly.

GAAS principles and the SASs should be looked on by practitioners as *minimum standards* of performance rather than as maximum standards or ideals. At the same time, the existence of auditing standards does not mean the auditor must always follow them blindly. If an auditor believes that the requirement of a standard is impractical or impossible to perform, the auditor is justified in following an alternative course of action. Similarly, if the issue in question is immaterial in amount, it is also unnecessary to follow the standard. However, the burden of justifying departures from the standards falls on the auditor.

When auditors desire more specific guidelines, they must turn to less authoritative sources, including textbooks, journals, and technical publications. Materials published

CHINA BLOCKS ACCESS TO AUDIT FILES

Ten years after the passage of the Sarbanes–Oxley Act of 2002 and the creation of the Public Company Accounting Oversight Board (PCAOB), audit firms are forbidden by the Chinese government from providing the Securities and Exchange Commission (SEC) or the PCAOB access to audit workpapers to conduct investigations surrounding financial statement reports and inspections of the audits conducted of Chinese entities. The PCAOB has been unable to examine the audit workpapers of more than 100 audit firms from China and Hong Kong, and without the permission of Chinese authorities neither the SEC nor PCAOB can obtain documents or interview witnesses.

Unfortunately, Chinese entities have fooled auditors and the continued lack of openness has led to widespread suspicion that Chinese audits are failing to uncover fraud concealed by Chinese clients. That suspicion has allegedly depressed share prices and increased the difficulty for Chinese entities to raise needed capital, even for honest organizations. For example, short-sellers have questioned whether the sales of Silvercorp Metals, a major silver mine in China, are overstated and whether the ore from the mine is of the quality the company claims. Silvercorp's financial statements are audited by the Canadian affiliate of one of the Big Four audit firms, but that firm relies on a Chinese affiliate to do much of the work. Without cooperation of the Chinese government, the SEC and PCAOB are unable to investigate, leaving lingering uncertainty about Silvercorp's financial statements.

SEC Chairwoman, Mary Shapiro has met with officials in Beijing, but it remains unclear whether access will be granted or the form of that access if allowed. U.S. officials might have access to audit workpapers to conduct their own investigations or they may only be allowed to watch Chinese inspectors in the room. Many wonder if Chinese officials will be willing to surrender controls to provide access to information.

Source: Floyd Norris, "In China, Little Urge to Audit the Auditors," *The New York Times* (July 13, 2012) (www.nytimes.com).

by the AICPA, such as the *Journal of Accountancy* and industry audit guides, furnish assistance on specific questions. We provide further study of the standards and make frequent reference to specific standards throughout the text.

QUALITY CONTROL

OBJECTIVE 2-7

Identify quality control standards and practices within the accounting profession.

For a CPA firm, **quality control** comprises the methods used to ensure that the firm meets its professional responsibilities to clients and others. These methods include the organizational structure of the CPA firm and the procedures the firm establishes. For example, a CPA firm might have an organizational structure that ensures the technical review of every engagement by a partner who has expertise in the client's industry. Auditing standards require each CPA firm to establish quality control policies and procedures. The standards recognize that a quality control system can provide only reasonable assurance, not a guarantee, that auditing standards are followed.

Quality control is closely related to but distinct from auditing standards. To ensure that the principles in auditing standards are followed on every audit, a CPA firm follows specific quality control procedures that help it meet those standards consistently on every engagement. Quality controls are therefore established for the entire CPA firm, whereas auditing standards are applicable to individual engagements.

Elements of Quality Control

Each firm should document its quality control policies and procedures. Procedures should depend on such things as the size of the firm, the number of practice offices, and the nature of the practice. The quality control procedures of a 150-office international firm with many complex multinational clients should differ considerably from those of a five-person firm specializing in small audits in one or two industries.

The system of quality control should include policies and procedures that address six elements. These are listed in Table 2-4 (p. 60) with brief descriptions and procedural examples that firms might use to satisfy the requirement.

Peer Review

Public accounting firms must be enrolled in an AICPA approved practice-monitoring program for members in the firm to be eligible for membership in the AICPA.

TABLE 2-4 Elements of Quality Control

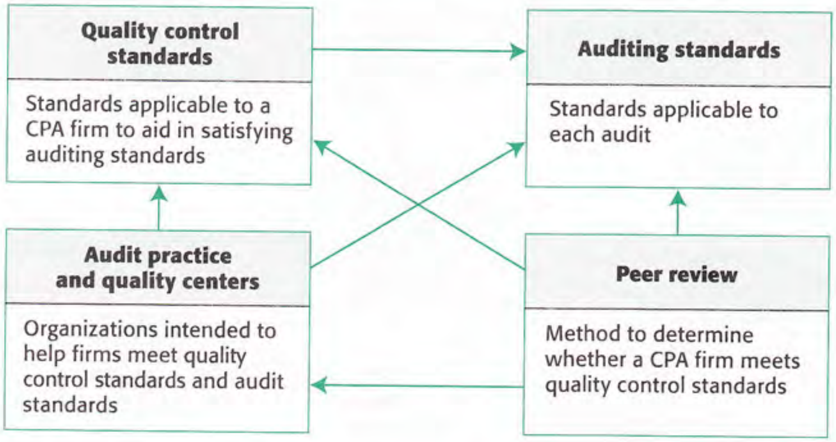
Element	Summary of Requirements	Example of a Procedure
Leadership responsibilities for quality within the firm ("tone at the top")	The firm should promote a culture that quality is essential in performing engagements and should establish policies and procedures that support that culture.	The firm's training 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 fact 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 clients and engagements	Policies and procedures should be established for deciding whether to accept or continue a client relationship. 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, 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.

Practice-monitoring, also known as **peer review**, is the review, by CPAs, of another CPA firm's compliance with its quality control system. The purpose of a peer review is to determine and report whether the CPA firm being reviewed has developed adequate quality control policies and procedures and follows them in practice. Unless a firm has a peer review, all members of the CPA firm lose their eligibility for AICPA membership.

The AICPA Peer Review Program is administered by the state CPA societies under the overall direction of the AICPA peer review board. Reviews are conducted every three years, and are normally performed by a CPA firm selected by the firm being reviewed, although the firm can request that it be assigned a reviewer through the administering state society. Firms required to be registered with and inspected by the PCAOB must be reviewed by the AICPA National Peer Review Committee to evaluate the non-SEC portion of the firm's accounting and auditing practice that is not inspected by the PCAOB. After the review is completed, the reviewers issue a report stating their conclusions and recommendations. Results of the peer review are included in a public file by the AICPA.

Peer review benefits individual firms by helping them meet quality control standards, which, in turn, benefits the profession through improved practitioner

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



performance and higher-quality audits. A firm having a peer review can further benefit if the review improves the firm's practice, thereby enhancing its reputation and effectiveness and reducing the likelihood of lawsuits. Of course, peer reviews are expensive to conduct, so the benefits come at a cost.

Audit Practice and Quality Centers

The AICPA has established audit practice and quality centers as resource centers to improve audit practice quality. The **Center for Audit Quality (CAQ)** is an autonomous public policy organization affiliated with the AICPA serving investors, public company auditors, and the capital markets. The Center's mission is to foster confidence in the audit process and to make public company audits even more reliable and relevant for investors. The Private Companies Practice Section (PCPS) provides practice management information to firms of all sizes.

In addition to these firm resources, the AICPA has established audit quality centers for governmental audits and employee benefit plan audits. Figure 2-3 summarizes the relationships among auditing standards, quality control, the audit practice and quality centers, and peer review in ensuring audit quality.

SUMMARY

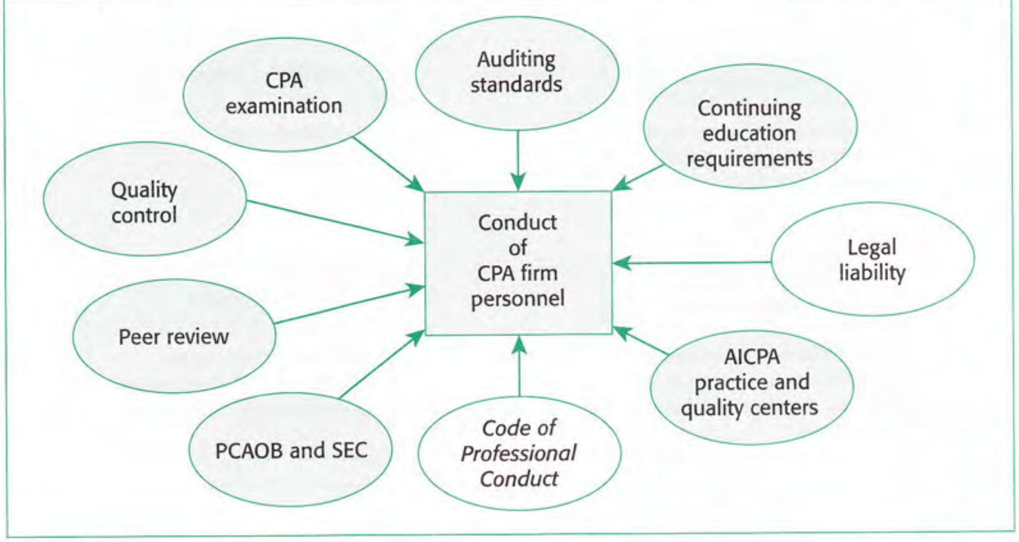
This chapter discussed the nature of the CPA profession and the activities of CPA firms. Because CPA firms play an important social role, several organizations, including the PCAOB, SEC, and AICPA, provide oversight to increase the likelihood of appropriate audit quality and professional conduct. These are summarized in Figure 2-4 (p. 62). Shaded circles in the figure indicate items discussed in this or the last chapter. The AICPA *Code of Professional Conduct* provides a standard of conduct for practitioners and is discussed in Chapter 5. The potential for legal liability is also a significant influence on auditor conduct and is discussed in Chapter 4.

ESSENTIAL TERMS

AICPA—American Institute of Certified Public Accountants, a voluntary organization of CPAs that sets professional requirements, conducts research, and publishes materials relevant to accounting, auditing, management consulting services, and taxes

Center for Audit Quality (CAQ)—an autonomous public policy organization with a mission to foster confidence in the audit process and to make public company audits even more reliable and relevant for investors

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



Generally accepted auditing standards (GAAS)—developed and issued in the form of Statements on Auditing Standards (SASs) and codified in AU-C sections in the *Codification of Auditing Standards*; often called *auditing standards*

International Standards on Auditing (ISAs)—statements issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants to promote international acceptance of auditing standards

Peer review—the review by CPAs of a CPA firm's compliance with its quality control system

Principles—framework helpful in understanding and explaining an audit; provide a structure for the *Codification of Statements on Auditing Standards*

Public Company Accounting Oversight Board (PCAOB)—board created by the Sarbanes–Oxley Act to oversee auditors of public companies, including establishing auditing and quality control standards and performing inspections of registered accounting firms

Quality control—methods used by a CPA firm to ensure that the firm meets its professional responsibilities to clients and others

Securities and Exchange Commission (SEC)—a federal agency that oversees the orderly conduct of the securities markets; the SEC assists in providing investors in public corporations with reliable information upon which to make investment decisions

Statements on Auditing Standards (SASs)—pronouncements issued by the AICPA to interpret the principles underlying generally accepted auditing standards

REVIEW QUESTIONS

2-1 (Objective 2-1) State the four major types of services CPAs perform, and explain each.

2-2 (Objectives 2-1, 2-7) What major characteristics of the organization and conduct of CPA firms permit them to fulfill their social function competently and independently?

2-3 (Objective 2-2) What is the role of the Public Company Accounting Oversight Board?

2-4 (Objective 2-3) Describe the role of the SEC in society and discuss its relationship with and influence on the practice of auditing.

2-5 (Objective 2-4) What roles are played by the American Institute of Certified Public Accountants for its members?

2-6 (Objective 2-4) What are the purposes of the AICPA *Statements on Standards for Attestation Engagements?*

2-7 (Objectives 2-2, 2-4, 2-5) Who is responsible for establishing auditing standards for audits of U.S. public companies? Who is responsible for establishing auditing standards for U.S. private companies? Explain.

2-8 (Objective 2-6) Distinguish between auditing standards and generally accepted accounting principles, and give two examples of each.

2-9 (Objective 2-6) Give a brief outline of the principles related to the auditor's responsibilities in the audit, and discuss important personal qualities that the auditor should possess based on auditing standards and codes.

2-10 (Objective 2-6) In some instances, the underlying AICPA standards could be considered too general for in-depth guidance, so auditors frequently turn to the SASs issued by the ASB for more specific guidance. Collectively, these statements constitute generally accepted auditing standards (GAAS) and are often referred to as auditing standards, SASs, or GAAS. Comment on and evaluate standards of performance.

2-11 (Objective 2-5) Describe the role of International Standards on Auditing. What is the relationship between International Standards on Auditing and U.S. auditing standards?

2-12 (Objective 2-7) What are the elements of quality control as it relates to a CPA firm?

2-13 (Objective 2-7) The following is an example of a CPA firm's quality control procedure requirement: "Any person being considered for employment by the firm must have completed a basic auditing course and have been interviewed and approved by an audit partner of the firm before he or she can be hired for the audit staff." Which element of quality control does this procedure affect, and what is the importance of having the requirement?

2-14 (Objective 2-7) State what is meant by the term *peer review*. What are the implications of peer review for the profession?

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

2-15 (Objectives 2-1, 2-2, 2-3) The following questions address CPA firms and entities that regulate them. Choose the best response:

a. Which of the following statements accurately describes U.S. CPA firms that are not sole proprietorships?
   (1) Most derive the majority of their revenues from tax services.
   (2) The most common organizational structure is the limited liability partnership structure.
   (3) The firm will be subject to an annual peer review.
   (4) The number of other professionals within a firm generally equals the number of partners in the firm.

b. You have been engaged to audit the final statements of a U.S. public company. Which of the following statements is correct?
   (1) Your firm must be registered with the PCAOB.
   (2) Your firm will be subject to auditing and quality control standards issued by the Securities and Exchange Commission.
   (3) Your firm must be either a National or Big Four CPA firm.
   (4) You will be engaged to audit both the quarterly and annual financial statements of your client.

2-16 (Objective 2-6) The following questions deal with auditing standards. Choose the best response.

a. Which of the following best describes what is meant by U.S. auditing standards?
   (1) Acts to be performed by the auditor.
   (2) Measures of the quality of the auditor's performance.

(3) Procedures to be used to gather evidence to support financial statements.
(4) Audit objectives generally determined on audit engagements.

b. The Responsibilities principle underlying AICPA auditing standards includes a requirement that
(1) field work be adequately planned and supervised.
(2) the auditor's report state whether or not the financial statements conform to generally accepted accounting principles.
(3) professional judgment be exercised by the auditor.
(4) informative disclosures in the financial statements be reasonably adequate.

c. What is the general character of the responsibilities characterized by the Performance principles?
(1) The competence, independence, and professional care of persons performing the audit.
(2) Criteria for the content of the auditor's report on financial statements and related footnote disclosures.
(3) The criteria of audit planning and evidence gathering.
(4) The need to maintain an independence in mental attitude in all matters pertaining to the audit.

2-17 (Objective 2-7) The following questions concern quality control standards. Choose the best response.

a. The nature and extent of a CPA firm's quality control policies and procedures depend on

	The CPA Firm's Size	The Nature of the CPA Firm's Practice	Cost-benefit Considerations
(1)	Yes	Yes	Yes
(2)	Yes	Yes	No
(3)	Yes	No	Yes
(4)	No	Yes	Yes

b. Which of the following are elements of a CPA firm's quality control that should be considered in establishing its quality control policies and procedures?

	Human Resources	Monitoring	Engagement Performance
(1)	Yes	Yes	No
(2)	Yes	Yes	Yes
(3)	No	Yes	Yes
(4)	Yes	No	Yes

c. One purpose of establishing quality control policies and procedures for deciding whether to accept a new client is to
(1) enable the CPA firm to attest to the reliability of the client.
(2) satisfy the CPA firm's duty to the public concerning the acceptance of new clients.
(3) provide reasonable assurance that the integrity of the client is considered.
(4) anticipate before performing any field work whether an unqualified opinion can be issued.

DISCUSSION QUESTIONS AND PROBLEMS

2-18 (Objective 2-6) Sarah O'Hann enjoyed taking her first auditing course as part of her undergraduate accounting program. While at home during her semester break, she and her father discussed the class and it was clear that he didn't really understand the nature of the audit process as he asked the following questions:

a. What is the main objective of the audit of an entity's financial statements?
b. The audit represents the CPA firm's guarantee about the accuracy of the financial statements, right?

c. Isn't the auditor's primary responsibility to detect all kinds of fraud at the client?

d. Given the CPA firm is auditing financial statements, why would they need to understand anything about the client's business?

e. What does the auditor do in an audit other than verify the mathematical accuracy of the numbers in the financial statements?

If you were Sarah, how would you respond to each question?

Required

2-19 (Objective 2-7) For each of the following procedures taken from the quality control manual of a CPA firm, identify the applicable element of quality control from Table 2-4 on page 60.

a. Appropriate accounting and auditing research requires adequate technical reference materials. Each firm professional has online password access through the firm's Web site to electronic reference materials on accounting, auditing, tax, SEC, and other technical information, including industry data.

b. Each office of the firm shall be visited at least annually by review persons selected by the director of accounting and auditing. Procedures to be undertaken by the reviewers are illustrated by the office review program.

c. Audit engagement team members enter their electronic signatures in the firm's engagement management software to indicate the completion of specific audit program steps. At the end of the audit engagement, the engagement management software will not allow archiving of the engagement file until all audit program steps have been electronically signed.

d. At all stages of any engagement, an effort is made to involve professional staff at appropriate levels in the accounting and auditing decisions. Various approvals of the manager or senior accountant are obtained throughout the audit.

e. No employee will have any direct or indirect financial interest, association, or relationship (for example, a close relative serving a client in a decision-making capacity) not otherwise disclosed that might be adverse to the firm's best interest.

f. Individual partners submit the nominations of those persons whom they wish to be considered for partner. To become a partner, an individual must have exhibited a high degree of technical competence; must possess integrity, motivation, and judgment; and must have a desire to help the firm progress through the efficient dispatch of the job responsibilities to which he or she is assigned.

g. Through our continuing employee evaluation and counseling program and through the quality control review procedures as established by the firm, educational needs are reviewed and formal staff training programs modified to accommodate changing needs. At the conclusion of practice office reviews, apparent accounting and auditing deficiencies are summarized and reported to the firm's director of personnel.

h. All potential new clients are reviewed before acceptance. The review includes consultation with predecessor auditors, and background checks. All new clients are approved by the firm management committee, including assessing whether the firm has the technical competence to complete the engagement.

i. Each audit engagement must include a concurring partner review of critical audit decisions.

j. The firm's mission statement indicates its commitment to quality, and this commitment is emphasized in all staff training programs.

2-20 (Objectives 2-5, 2-6) You have been asked to make a presentation in your International Business class about how globalization is impacting the auditing profession. In preparation, you met with your auditing professor and discussed these questions:

a. What organizations are responsible for establishing U.S. auditing standards used by CPA firms when auditing financial statements prepared by organizations based in the U.S.?

b. What organization is responsible for establishing auditing standards internationally?

c. To what extent are AICPA auditing standards and international auditing standards similar?

d. What is the process the AICPA Auditing Standards Board (ASB) uses to develop AICPA auditing standards?

e. To what extent are PCAOB auditing standards impacted by international standards?

Required Briefly outline key points that you would make in your presentation to address these questions.

2-21 (Objective 2-6) Ray, the owner of a small company, asked Holmes, a CPA, to conduct an audit of the company's records. Ray told Holmes that an audit was to be completed in time to submit audited financial statements to a bank as part of a loan application. Holmes immediately accepted the engagement and agreed to provide an auditor's report within 3 weeks. Ray agreed to pay Holmes a fixed fee plus a bonus if the loan was granted.

Holmes hired two accounting students to conduct the audit and spent several hours telling them exactly what to do. Holmes told the students not to spend time reviewing internal controls but instead to concentrate on proving the mathematical accuracy of the ledger accounts and summarizing the data in the accounting records that support Ray's financial statements. The students followed Holmes's instructions and after 2 weeks gave Holmes the financial statements, which did not include footnotes. Holmes reviewed the statements and prepared an unqualified auditor's report. The report did not refer to generally accepted accounting principles or to the consistent application of such principles.

Required Briefly describe each of the principles underlying AICPA auditing standards and indicate how the action(s) of Holmes resulted in a failure to comply with each principle.

Organize your answer as follows:*

Brief Description of Principle	Holmes' Actions Resulting in Failure to Comply with the Principle

2-22 (Objective 2-5) For each engagement described below, indicate whether the engagement is likely to be conducted under international auditing standards, U.S. generally accepted auditing standards, or PCAOB auditing standards.

a. An audit of a U.S. private company with no public equity or debt.

b. An audit of a German private company with public debt in Germany.

c. An audit of a U.S. public company.

d. An audit of a United Kingdom public company that is listed in the United States and whose financial statements will be filed with the SEC.

e. An audit of a U.S. not-for-profit organization.

f. An audit of a U.S. private company to be used for a loan from a publicly traded bank.

g. An audit of a U.S. public company that is a subsidiary of a Japanese company that will be used for reporting by the parent company in Japan.

h. An audit of a U.S. private company that has publicly traded debt.

RESEARCH PROBLEM 2-1: INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD

International Standards on Auditing (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB). Use the IAASB Web site (http://www.ifac.org/IAASB/) to learn more about the IAASB and its standard-setting activities.

Required

a. What is the objective of the IAASB? Who uses International Standards on Auditing?

b. Summarize the due process followed by the IAASB in setting standards.

c. How is the IAASB committed to transparency in the standard-setting process?