

Chapter 2 The Public Accounting Profession

Chapter opener: Leveraging the Power of Professional Judgment

1. Virtually any industry could be listed as a specialization, even banking, as there are some small credit unions that would fall under banking. Key is that the student explains how the specialization is acquired (e.g. by reading the standards, having worked in the industry, or practice with a group of clients).
2. Read the standards, attend training, review each other's work, consult with peers, and likely others.
3. Attend seminars offered by the industry, read the legislation, work with these organizations on an ongoing basis to find out and stay current with what is happening for them.

Audit Challenge

2-1 National and Regional CGA Firms

1. They would be looking for members that are current in their field, have good quality control practices, have a good reputation in their community, and are competent. The prospective members would likely also need to be qualified PAs and professional accountants.
2. They could ask about the nature of the quality control practices in place, as well as the results of peer review from the local professional accounting association. They could also engage in their own peer review, have members from one firm location assess the work of another location.

Concept Check Answers

C2-1 Large international or national firms have more specialist functions and a greater variety of support resources. They also have the resources and skills to audit publicly listed organizations from many different industries. Smaller, local firms may have only one or two partners who serve local business.

C2-2 Websites can be used to provide information to clients, including results of research that could attract potential new clients. The Internet can also be used to transfer information back and forth among staff, including the use of Internet video conferencing to discuss working papers. This is particularly useful for international clients.

C2-3 Factors that contribute to a PA's competence are training, quality control standards, professional rules of conduct, regulatory agencies, and continuing research.

C2-4 They provide professional guidance and continuing professional education. They also conduct practice inspection.

C2-5 The CICA, CGAAC, SMAC and IFAC are involved in setting standards. (In the U.S., the PCAOB is also involved in setting standards.)

C2-6 Professional rules of conduct and GAAS provide the framework for conducting an effective audit. The PA firm could have quality control monitored or enforced by members of its own firm, by the provincial CA, CGA or CMA institute, or by the CPAB for publicly listed clients.

C2-7 Poorly completed audits could result in incorrect audit opinions, resulting in increased audit costs or loss of confidence in the PA profession. The PA and PA firms could also be sued (increased legal liability).

Review Questions

2-1 A small practitioner may work with a broad diversity of small clients, getting to know her customers well, perhaps doing detailed work such as tax planning. She would also be responsible for administrative, continuing education, quality control and marketing for the practice. A larger firm enables having different people doing the different tasks, such as marketing, administration, human resources, and support for quality assurance. There would also be an opportunity for working at diverse clients of different sizes.

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

1. *Organizational form* A PA firm exists as a separate entity to avoid an employer-employee relationship with its clients. The PA 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 PA 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 PA firms in an attempt to keep competence high.

2-3 The answer to the first question will vary by province. For example, in Ontario, LLPs are permitted.

Differences between a partnership and an LLP: In a normal partnership, each partner normally could be liable to the full extent of his or her personal assets in the event of partnership lawsuits, and would share in profits based upon the partnership agreement. In a Limited Liability

Partnership (LLP), one or more partners have limited liability (normally limited to the extent of their capital contribution), while one or more partners is designated as having unlimited liability. The LLP could also be structured so that all partners have limited liability, based upon the legislation where the LLP was established.

A firm would choose to organize as an LLP to protect the assets of its partners.

2-4 The PA firm could have a web site to illustrate the services provided by the firm, to gain potential clients, and also to gain potential employees or partners. The internet could also be used as a vehicle for internal communications, as employees can use the internet for email, to send files back and forth, to hold teleconferences, or to facilitate the firm's intranet. The firm could also use application service providers (ASP) for its own accounting. It could also outsource client work, for example some firms sent their client tax returns to other countries for processing.

2-5 The *CICA Handbook* provides guidance in general circumstances to service the largest numbers of situations and users. Where there is no guidance in the *Handbook*, accountants rely on their professional judgment to fairly present the economic reality of the situation. Leaving the application open to judgment may result in general acceptance of a minimum level of auditing or accounting practice.

- The existence of standards is a means of transmitting wisdom and avoiding unintentional error due to ignorance.
- Standards may be a more efficient and desirable way of creating a body of knowledge about acceptable financial reporting frameworks or GAAS than expensive lawsuits and the development of case law.
- Compliance with a documented set of standards can provide a better defense against legal liability.
- If the Standards Boards did not develop standards, then other groups or agencies would.
- Standards instill confidence in the fairness and reliability of financial statements to users.
- On the other hand, market research suggests that too many standards are ineffective in assisting the operation of the market.
- Standard setting is expensive for the profession; the costs may exceed the benefits.
- Given the complexity of the economic reality that financial statements attempt to portray, no set of standards can be theoretically correct or deal appropriately with all situations.

2-6 By organizing standard-setting, the independent Boards associated with the CICA provide a framework that can be used for engaging in public accounting.

The CICA/CGAAC/SMAC conduct research and publish materials on many different subjects related to accounting, auditing, management advisory services, and taxes. These research materials enable professional accountants to stay current in their profession, or to take continuing education on the topics of their choice.

The organizations also prepare and grade the CA, CGA, and CMA accounting examinations, respectively. This is a high cost service that helps to ensure standardization of knowledge at the entry level of these professions.

2-7 The *CICA Handbook* codifies as recommendations, the standards associated with several acceptable financial reporting frameworks (such as ASPE and IFRS), and generally accepted auditing standards (GAAS). In addition, the *Handbook* includes Accounting Guidelines and Assurance and Related Services Guidelines. The Guidelines are either interpretations of the recommendations, or a statement on a matter of concern. The *Handbook* is prepared by the CICA, which serves two main functions: 1) it is the umbrella organization to which all CAs belong, and 2) it has been given the authority by the *Canada Business Corporations Act* and the various provincial incorporating acts to set the accounting and auditing standards that must be followed by public accountants doing audits of companies chartered under one of the acts.

2-8 *Generally accepted auditing standards* are general guidelines to aid auditors in fulfilling their professional responsibilities. These guidelines include standards concerned with adequate technical training and proficiency in auditing, due care, and an objective state of mind; examination standards including planning and supervision, understanding and evaluation of internal control, and the gathering of sufficient appropriate evidential matter; and standards of reporting including identification of the responsibilities of management and the responsibilities of the auditor with respect to the financial statements, the scope of the examination, and an opinion on the financial statements as to whether the financial statements present fairly the financial position, results of operations and changes in financial position in accordance with an appropriate financial reporting framework.

Generally accepted accounting principles are specific rules for accounting for transactions occurring in a business enterprise that relate to a particular financial reporting framework, such as ASPE or IFRS.

Examples may be any of the Accounting Recommendations (GAAP from an appropriate financial reporting framework) and Assurance Recommendations in Sections or in CASs (GAAS) of the *CICA Handbook*.

2-9 An objective state of mind helps the PA evaluate evidence without bias. Due care embodies the concept that a PA does his or her best during the engagement, helping to provide high quality field work and results.

2-10 The large-scale business failures of Enron and WorldCom affected public confidence in auditors worldwide. In the U.S., this resulted in the Sarbanes-Oxley legislation in 2002, and in Canada, in CSA rules that provided for an additional layer of quality control. In Canada, the Canadian Public Accountability Board is now responsible for conducting peer review of audit firms that audit public companies.

2-11 SOX (Sarbanes-Oxley) was passed in the U.S. in 2002. At that time, the PCOAB was created, mandated to develop additional auditing standards for public companies in the U.S. The requirements of SOX resulted in more stringent rules for boards of directors and audit committees, and added certification by the CEO (chief executive officer) and other senior management with respect to the financial statements. Section 404 of that act also implemented

management certification of internal controls for publicly listed corporations, which was to be audited.

Canada initially mirrored this legislation by means of regulations passed by the CSA (Canadian Securities Association). However, using industry and other feedback, Canada's securities regulators implemented a revised MI (multilateral instrument) numbered 52-109 in 2008, which has some key differences from the U.S. Two of these differences are that management's certification over internal controls does not have to be audited, and the second is that there is an exemption from the internal control certification for venturers – small publicly listed companies that are listed on the venture exchanges (often called penny stocks).

2-12 The CPAB provides quality assurance of the financial statement audit of public companies, by assessing the work of PAs conducting such audits. Firms must register with the CPAB and be subject to quality control assessment by the CPAB.

2-13 International Standards on Auditing (ISAs) are developed for broad use around the world, and are the basis for international GAAS. Member countries from around the world contribute to the development and assessment of standards. Firms who conduct an audit with local GAAS (such as Canadian GAAS) may not be in compliance with ISAs, since local standards often differ.

2-14 Quality controls are established by individual public accounting firms to help ensure that their firm meets its professional responsibilities to clients. Quality controls are the procedures used by a public accounting firm that help it meet generally accepted auditing standards consistently on every engagement. Quality controls are therefore established for the entire public accounting firm as opposed to individual engagements.

2-15 A practice inspection is a review, by practice inspectors employed by the provincial institute or *ordre*, of a public accounting firm's compliance with its quality control procedure system for auditing and accounting engagements and its compliance with the *CICA Handbook*. Practice inspection is mandatory in those provinces that have instituted it. The discussion in the text pertains to CAs in public practice in Ontario or CGAs in public practice in B.C.

Practice inspection can be beneficial to the profession and to individual firms. By helping firms meet quality control standards, the profession gains if inspections result in practitioners doing higher quality audits. A firm having a practice inspection 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, practice inspections are costly. There is always a trade off between cost and benefits. A PA firm also gives up some independence of activities when it is reviewed by the practice inspectors. The consensus is that practice inspection has been successful in increasing the quality of public practice.

Discussion Problems

2-16 a. PAs can provide the following information and web links on their firm websites:

- Office locations or affiliations
 - Lines of service the firm provides (audit, tax, management consulting, etc.)
 - Industry specialization information for the firm
 - Online software tools and databases
 - Latest tax law developments applicable to clients
 - Calculators for retirement account decisions
 - Online privacy management software
- b. PA firms invest their resources to develop sophisticated websites largely because of a desire to maintain a client-service approach. Increased competition motivates PA firms to improve the traditional paths of providing information to their clients. A PA firm can reach clients more quickly and efficiently with vital information via the firm's website than through more traditional forms of communication, such as a monthly or quarterly newsletter. Also, as more clients become sophisticated in the area of technology, they expect their PA firms to do the same by providing a useful website that has links to other helpful tools and resources.
- c. The Internet is a useful tool for a PA firm's accounting and auditing practice in many ways. A firm's website can be used to market the firm's accounting and auditing practice. The Internet also connects the firm's global professional staff, making it easier for staff from all over the world to provide client service on a timely basis without having to be physically present at the client's location. PAs also use online resources and databases to remain current on emerging business and standards-setting issues. Examples include *Standard and Poor's Net Advantage Database* and *Goldman Sachs Research Database*. These two databases provide extensive industry-specific information and coverage of companies that PAs use on a subscription basis to stay current on industry developments and to obtain industry data useful for auditing and consulting.
- 2-17** a. Engagement performance: provides access to current standards and material to answer technical queries
- b. General human resource policies and Engagement performance: The partner and manager provide adequate supervision for field work, while continuity helps ensure efficiency and knowledge of business.
- c. Engagement performance: Electronic signatures (passwords) help maintain authorized access, while the electronic prevention of archiving helps ensure that all documentation is completed.
- d. Engagement performance: Staff feedback and queries help ensure that all views are considered and encourages staff at all levels to bring forward unusual items for discussion while approvals ensure that adequate professional judgment has been used in the development and execution of audit steps.
- e. General ethical requirements and Independence: Ensures compliance with independence rules.

- f. Engagement quality control review: Ensures that adequate quality control review is completed by those not involved in the engagement.
- g. Client acceptance or continuance: Only clients that fit the risk profile of the firm are accepted as continuing clients.
- h. General human resource policies: Only competent, high quality individuals are promoted to partner.
- i. General human resource policies: Engagement deficiencies are identified and remedied; all staff receive necessary continuing education.

2-18 Note the following supplemental information:

The comments in the problem do summarize the beliefs of some practitioners about quality control and practice inspection. The arguments against quality control and practice inspection are stated in the comments and can be summarized as five basic arguments.

- (1) Relative cost for smaller firms is excessively high.
- (2) Smaller firms have less need for quality control because of greater partner involvement.
- (3) It eliminates the major competitive advantage of smaller firms which is a simple and efficient organizational structure.
- (4) Quality control standards are not needed because they have already been implemented by quality firms.
- (5) Three other things already provide assurance of adequate quality: auditing standards, legal liability, and a competitive economic environment.

To support these comments it can be argued that the profession has functioned well with relatively little controversy and criticism. A major reason many practitioners choose the profession is the relative freedom to operate their professional practice as they see fit.

Solution to text problem

- a. The arguments against these comments are primarily as follows:
 - It will not be costly for most smaller firms to implement quality control requirements because the quality control standards required are not onerous unless the firm chooses to register with the CPAB and conduct public company audits
 - There is no need to eliminate the simple organizational structure now enjoyed by many smaller public accounting firms.
 - Certain critics of the public accounting profession have argued strongly against self-regulation of the profession. Many public accountants believe that only through self-regulation will it be possible to minimize government interference. Even if the elements of quality control enunciated by the text are in existence, the quality control and practice inspection requirements may be necessary to avoid government interference.
 - For those firms that already have the necessary elements of quality control in their practice, the additional implementation costs should be minimal. Those lacking such elements will incur more cost, but presumably are lacking in certain elements needed for a high quality practice.

- Partner involvement on engagements does not necessarily ensure that all quality control requirements have been met. For some smaller firms, top partners may spend relatively little time on audits and therefore not be as knowledgeable about auditing as may be necessary.
- b. There is no correct answer to this question. Different people reach different conclusions, depending on the weights put on each of the arguments stated in Part a, for and against quality controls and practice inspection. The authors believe that both quality control and practice inspection are worth the cost.

The post-Enron (and other accounting problems such as Nortel in Canada) have resulted in an increased emphasis on quality control and practice inspections.

Professional Judgment Problem

2-19

- a. Rossi and Montgomery's primary consideration is their professional competence to perform all of the audit work for filing with the OSC. In addition, if Rossi and Montgomery have performed bookkeeping services or certain consulting services for Mobile Home, they will not be independent under the independence requirements.
- b. The filing with the OSC, in addition to normal audited financial statements, will require completion and registration with the OSC of specific forms by the client and by the auditor. The auditor needs to have an understanding of the requirements of these documents in addition to the completion of the audit. Additional documents must be filed by the client and the auditor within a specific time period after every quarter (usually 45 days) and after the year end (usually 90 days). These documents must adequately disclose the results of financial operations and any related party transactions.

The audit firm must be registered with the CPAB (Canadian Public Accountability Board), pay the appropriate fees, and be subject to quality control review from the CPAB.

Case

2-20 Violation: Both Liu & Liu and Cheng have violated generally accepted auditing standards in the conduct of this engagement.

While it was appropriate for Liu & Liu to accept the engagement after not hearing from the predecessor auditors for one month, professional skepticism would require them to investigate why the predecessor auditor resigned unexpectedly during the fiscal year. In addition, the fact that the predecessor issued an unqualified opinion last year is not enough to establish the fairness of the opening balances. Normally, a successor auditor would review the working papers of the predecessor to ensure that necessary audit procedures were performed. Since the predecessor did not communicate with Liu & Liu, the new auditors must themselves perform appropriate audit procedures to verify the opening balances. This was not done.

Chapter 2: The Public Accounting Profession

In addition, Cheng appears to lack adequate knowledge and experience to audit the financial statements of a financial institution. While she performed the audit as instructed, her lack of experience implies that her professional judgment in designing appropriate procedures and evaluating evidence would be questionable. For example, there was no field work conducted to relate the client to the business environment or to gather knowledge of the business environment in addition to knowledge about the client.

Due to the lack of experience, Cheng's work would require close supervision by a more experienced auditor, which would be difficult (or likely did not occur) since this is the firm's first credit union client.

Although standards permit an auditor to understand the client's business and controls but not rely upon them, in today's highly automated banking environment, it is likely that the auditor could not effectively conduct the audit without relying upon some automated controls.

Ongoing Small Business Case: Planning for CondoCleaners.com

2-21 All businesses need to accurately record the transactions that are processed, so this would be similar for both the accounting and cleaning business. Similarly, they need to follow local, provincial and national regulations during their operations. They would also need to file income tax returns, and be profitable to stay in business.