

## Chapter 2

# The Public Accounting Profession and Audit Quality

### Concept Check Questions

**C2-1** *How are public accounting firms organized?*

A typical public accounting firm is organized in a hierarchical manner with partners being the highest level. Below partner would be senior managers, managers, seniors or in-charge auditors, and staff accountants. The titles of the positions vary from firm to firm, but the basic structure is the same in all of them.

**C2-2** *What external factors ensure that audit and assurance engagements are completed at high standards of quality?*

The factors include: high quality standards (national and international), the national (with the national exams) and provincial accounting associations (continuing education requirements, practice inspections and code of conduct), CPAB (provides oversight of public company audits) and legal liability. Figure 2-4 summarizes how the profession and society ensures that audit engagements are of a high quality.

**C2-3** *Which organizations develop and maintain the standards that public accountants use. Identify three organizations involved in standard setting for the PA profession.*

The CPA Canada, AASB, and IFAC are involved in setting standards.

**C2-4** *Describe the principles underlying Canadian Auditing Standards and explain their purpose.*

The principles underlying the CAS are related to the auditor's responsibilities in the audit stress important qualities that the auditor should possess including professional competence and due care, compliance with ethical and independence requirements, professional skepticism and professional judgment, and comprehensive performance. These principles ensure auditors carry out audits in compliance with GAAS and protect the public interest.

**C2-5** *What factors affect audit quality?*

According to CPAB, the four key factors that affect audit quality are: having the right teams, providing the right support, in-process reviews, and ensuring that someone is accountable for audit quality. The first three factors are directly related to performing the audit engagement. The last factor is related to the firm's quality control processes. At the firm level, there are various factors that affect audit quality – including firm leadership (tone at the top), processes to ensure auditors are independent and follow the ethical requirements, client acceptance and continuance policies, human resource policies, and monitoring processes.

## **C2-6** *What is quality control and how is it monitored?*

Quality control is the policies and procedures used by a public accounting firm to make sure that the firm meets its professional responsibilities. Firms will have policies related specifically to audit engagements as well as policies for the overall firm.

Professional rules of conduct and GAAS provide the framework for conducting an effective audit. GAAS includes specific guidance for quality control standards for the firm as well as for the individual engagements. The PA firm could have quality control monitored or enforced by members of its own firm, by the provincial CPA association, or by the CPAB for publicly listed clients.

## **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. *Practice Inspection* 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 *CPA Canada 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.

**2-5** The *CPA Canada 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 CPA Canada, which serves two main functions: 1) it is the umbrella organization to which all PAs 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.

**2-6** The AASB is responsible for setting standards. It is supported by CPA Canada, who issues the CPA Assurance Handbook.

**2-7** In Canada, the AASB sets standards for both private and public companies. Canadian audit standards follow international standards. In the United States, the AICPA sets standards for private companies (these standards are converged with international standards). The PCAOB sets standards for public companies and while they are similar to international standards they do not necessarily follow international standards. (Recall the auditors of American public companies provide an opinion on the effectiveness of internal controls as well as the financial statements.

**2-8** The CPAB provides quality assurance of the financial statement audit of public companies, by assessing the work of PAs conducting such audits. Firms who perform public company audits must register with the CPAB and be subject to quality control assessment by the CPAB.

**2-9** 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.

**2-10** *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 *CPA Canada Handbook*.

**2-11** Competence and capabilities contribute to a PA's qualifications to conduct a financial statement audit. PAs fulfill these responsibilities through their university education and the training that is involved in obtaining the CPA designation. Ongoing learning occurs through increased experience and consultation with peers and supervisors. PAs also continue to update their knowledge and skills through professional development.

**2-12** The objectives of the financial statement audit are:

- Providing reasonable assurance that the financial statements are not materially misstated;
- Consideration of both potential fraud or error;
- Communicating whether the financial statements comply with an applicable financial reporting framework using the expression of an opinion;
- Reporting on the financial statements; and
- Communicating auditor findings in accordance with the CASs.

**2-13** The PCAOB defines audit quality as meeting investors' needs for reliable and independent audits – this definition emphasizes that the auditors' key role is protecting the public interest and serving financial statement users' needs. According to the CPAB, the four key areas that have a significant impact on audit quality are the competence of the right audit team, the support provided to the audit teams, the review process, and ensuring that accountability for audit quality is assigned to the appropriate individuals.

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

**2-16** 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 *CPA Canada Handbook*. Practice inspection is mandatory in those provinces that have instituted it.

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 tradeoff 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.

## Multiple Choice Questions

**2-17** (1)

**2-18** a. (2)      b. (3)      c. (3)

**2-19** a. (1)      b. (2)      c. (3)

## Discussion Problems

**2-20**

- a. The main objective of an audit of financial statements is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion in a written report on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework.
- b. No. In an audit of the financial statements, the auditor performs audit procedures to obtain reasonable assurance about whether the financial statements contain material misstatements. While a high level of assurance, reasonable assurance is less than a guarantee—which implies absolute (100%) assurance. In an audit, the auditor issues an opinion on whether the financial statements are presented fairly, but the auditor is not guaranteeing that the financial statements are accurate with certainty.

- c. No. Fraud is a broad legal concept that describes any intentional deceit meant to deprive another person or party of their property or rights. The auditor does not take responsibility for detecting all types of fraud, given many types of fraud do not impact the financial statements. Instead, the auditor performs auditing procedures to obtain reasonable assurance that the financial statements do not contain material misstatements, whether due to fraud or error. Thus, the auditor is concerned with detecting fraud that leads to a material misstatement. The auditor is not responsible for detecting fraud that does not lead to a material misstatement.
- d. Each entity faces a number of risks unique to the nature of its business and industry. The types of operations, the extent of regulation, how the organization obtains capital to fund its business model, and the nature of accounts in the financial statements, among other factors, each trigger different types of risks that could lead to material misstatements. In addition, there are unique accounting standards for certain industries that impact how transactions, accounts, and disclosures are reported in financial statements. Thus, a thorough understanding of the client's business is critical to assessing the risk of material misstatements in the financial statements when planning the audit.
- e. The auditor is responsible for obtaining sufficient appropriate audit evidence about whether the financial statements are free of material misstatements. In addition to understanding whether the amounts reported in the financial statements are mathematically accurate, the auditor obtains other types of information to determine that the amounts reported represent valid transactions and accounts and that all valid transactions and accounts are included in those statements. Evidence is also gathered to determine that the entity has the rights to assets and has the obligation to repay liabilities reflected in those financial statements and whether the correct disclosures are included in the financial statements as required by accounting standards.

## 2-21

- 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.
- j. Client acceptance and continuance: Clients are screened to determine any issues regarding integrity or aggressive accounting. Only clients for which the firm has required competence are accepted.
- k. Engagement performance: Concurring partner review helps provide insight from a knowledgeable and experienced auditor who has not been directly involved in the engagement.

**2-22** 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.

- 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 the recent financial crisis have resulted in an increased emphasis on quality control and practice inspections.

## **Professional Judgment Problems and Cases**

### **2-23**

- 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.

- c. Since the public accounting firm has not performed a public company audit in the past, the key issue would be regarding whether the auditors' personal responsibilities is whether or not they would have the necessary competence and capabilities. It follows from this, if they do not have the necessary knowledge, they may not be able to exercise appropriate professional judgment. Regarding the performance requirements, it would cause to question whether the auditors would have the skills/knowledge to plan and supervise the audit appropriately.
- d. Refer to Table 2-5 for the elements of Quality Control. One could argue that all the elements could apply to this situation; however, it would be necessary to provide an adequate explanation of how they would apply to this specific situation.



- Leadership Responsibilities – An appropriate tone at the top would not pressure practitioners to take on clients which it is beyond its capabilities;
- Human Resources – it would be necessary to ensure all the engagement team have adequate training regarding public company audits.
- Client Acceptance and Continuance – If the firm has appropriate client continuance procedures in place then it would be able to make an informed decision as to whether or not it can provide a quality audit
- Engagement Performance – The firm would need to ensure that its procedures encompass the requirements for public company audits.
- Monitoring – Public company audits should all have a practitioner with public company audit experience involved in the monitoring process.

## 2-24

- a. Given that auditing is a business, public accountants routinely have to balance commercialism and professionalism. If a firm places too much focus on commercialism, it may encourage auditors to focus more on developing business than on performing a quality audit. Some even claim that it may compromise auditor independence and auditors will be easily swayed by the client's arguments. In the aftermath of the Enron and WorldCom collapses, there was much discussion around this theme – particularly in relation to the role of consulting services and how they had eroded the emphasis on professionalism. As one senior auditor in the American profession stated “Health skepticism had been replaced with concurrence.” (from Arthur R. Wyatt. 2004. Accounting Professionalism – They Just Don't Get It! *Accounting Horizons*. 18(1): 45-53).
- b. CPAB has expressed concern that because some view the annual audit as a commodity, firms may lower fees and, as a result, will attempt to maintain profit margins at the expense of audit quality. Some controls that CPAB has recommended that firms can put in place are:
  - Develop an accountability culture which starts with the audit firm's CEO (tone at the top) – this type of culture should support “doing the right thing.” In addition, individual auditors should have the authority to deal with quality issues that affect audit quality.
  - Firms should have policies in place that ensure audit teams have sufficient time to complete a quality audit.
  - Audit quality should be part of performance evaluations.

## 2-25

- a. There is no real right or wrong answer to this question. Proponents of AQIs would argue that it provides an objective measure of various factors that are considered to impact audit quality. However looking solely at quantitative measures will not necessarily tell the whole story, since certain components of audit quality, such as due care, independence, professional judgment and professional skepticism, cannot be quantified. It also does not capture how the audit firm or audit team is able to deal with the unexpected.

Also, there has not been firmly established that some of the measures being proposed are have a direct impact on audit quality. Perhaps most importantly, despite all the talk about audit quality there is no clear definitive definition on what exactly is audit quality. Further, some as the audit techniques evolve, static measures of quality may not be very useful. Given that it is somewhat difficult to argue that the measures are indeed that useful.

- b. Given the push for greater transparency regarding the audit process, many would argue that publishing AQIs would be helpful for financial statement users and clients. However, some one argue that since it is difficult to determine what exactly the measures mean, publishing this data would be of little use and could be misleading and people who do not have inside information regarding the audit could come to incorrect or incomplete conclusions.

c.

Element	Audit Quality Indicator	Example Calculation
Leadership and Tone at Top	How top leadership is being viewed by audit staff	Results of Independent Survey of Firm Personnel
Human Resources	All personnel participate in continuing professional education and professional development training.	Average training hours/year per staff level
Engagement Performance	Adequate partner involvement in all phases of audit	Percentage of partner hours spent on an audit compared to total hours
	Adequate allocation of audit hours to phases in the audit	Firm Level - Percentage of hours of the firm devoted respectively to planning, quarterly reviews, interim field work, final field work up until report release date, and post-field work until audit documentation completion date for partners, managers and audit staff Engagement Level - Current year's (planned) and prior year's (actual) total chargeable hours or each related audit phase
Monitoring	Quality Review Results	Summary of audit firm's internal quality results CPAB Inspection Results

**Instructor Note:**

To further enrich this question, you might ask your students to access the transparency report of one of the Big 4 firms. Several of the large firms in Canada have begun to issue transparency reports. The transparency reports tend to use the quality control framework to describe audit quality and to demonstrate the types of control procedures and processes. Some are starting to use objective measures of audit quality as well.

These reports focus on the governance of the firms and tend to highlight that they have a code of conduct, carefully monitor independence, carefully screen potential clients, staff and partners are evaluated based upon audit performance, there are professional development requirements, policies regarding supervision and review, a standard audit methodology, audit partner remuneration is based solely on profits (no bonuses/incentives for selling services).

Some information which students may find interesting is the breakdown of revenue by major services, assurance, tax, and consulting, as well as details on partner remuneration.

The usefulness of the reports is debatable. Academic research tends to conclude that the reports are not that useful in distinguishing the firms along the lines of audit quality. Whether Canada's regulators should require firms to issue transparency reports is again open for debate. It seems that the regulator themselves has access to better information through their reviews but, based upon the current reports, it is not clear whether being more transparent to the investing public is achieving the regulators' goal.

**2-26 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.

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.

Cheng and her firm did not seem to act with due care – particularly since credit unions regulated and would require the auditor to have specialized knowledge. For instance, the regulator relies upon the financial statements to assess whether Demonte meets the conditions of its deposit insurance appears. Cheng also appears to have not acted with appropriate skepticism and overly relied upon the CFO for explanations.

Due to the lack of experience and knowledge, 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. Further, the engagement partner's cursory review suggests he did not fulfill his responsibilities. The comments by the CFO also suggest that the entire audit was not performed with due care – the previous auditors spent more time and assigned more staff to the audit.

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.

## 2-27

- a. **Audit Quality Blog** - It is an e-communications tool to help keep stakeholders in financial reporting (auditors, regulators, preparers, audit committee members, and investors) up to date with the improvements to audit quality and to engage the various stakeholders. It does the following:
  - Provides links to useful audit quality resources (from around the world)
  - Shares relevant information from a wide variety of sources (business investment circles, accounting professionals, academics, standard setters, and regulators)
  - Provides a discussion forum (the site is hosted by CPA Canada and participants can post to the discussion forum)
- b. Instructors may select a link to a *Previous Post* that either relates to the material covered in this chapter (GAAS, quality control, audit quality, standards setters) or later chapters such as Chapters 3 (Legal Liability and Professional Judgment,) or ones which focus on the audit process (Chapters 4 to 10). This question can easily be scaled up or down to become a research assignment for the course.