

Chapter 2

The Audit Standards' Setting Process

Learning Objectives

- 1 Describe the nature of CPA firms, what they do, and their structure.
- 2 Understand the role of the Public Company Accounting Oversight Board and the effects of the Sarbanes-Oxley Act on the CPA profession.
- 3 Summarize the role of the Securities and Exchange Commission in accounting and auditing.

Learning Objectives

- ④ Describe the functions performed by the AICPA.
- ⑤ Understand the role of international auditing standards and their relation to U.S. auditing standards.
- ⑥ Use U.S. auditing standards as a basis for further study.
- ⑦ Identify quality control standards and practices within the accounting profession.

Certified Public Accounting Firms

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.

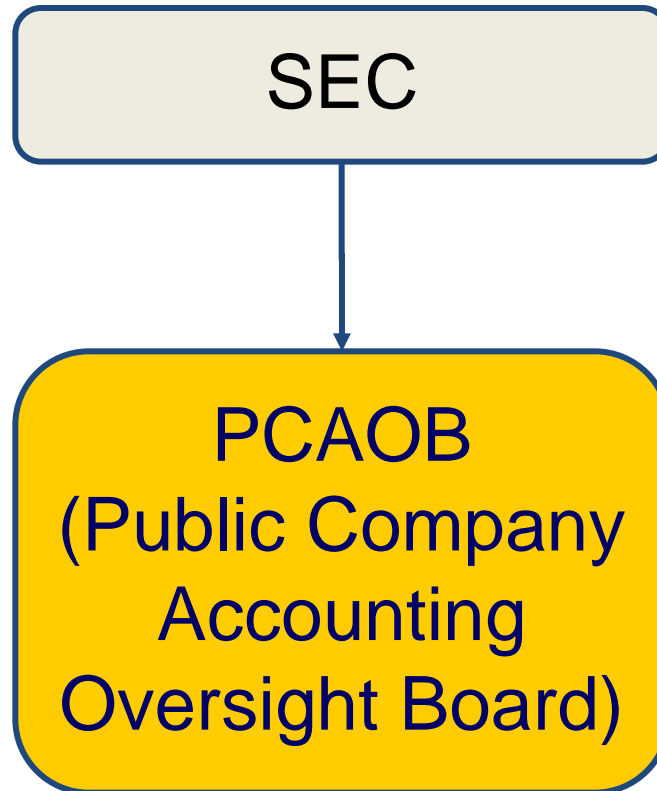
Source: Data from *Accounting Today* (www.accountingtoday.com).

Sarbanes-Oxley Act

This Act is considered by many observers to be the most important legislation affecting the auditing profession since the 1930s.

The provisions of the Act apply to publicly held companies and their audit firms.

Sarbanes-Oxley Act



Understand the role of the PCAOB and the effects of the Sarbanes Oxley Act on the CPA profession

- Because of the bankruptcies and alleged audit failures involving such companies as Enron and Worldcom, **SOX is considered by many to be the most important legislation affecting the auditing profession since the 1933 & 1934 Securities Acts.**
- SOX established the Public Company Accounting Oversight Board (PCAOB), appointed and overseen by the Securities and Exchange commission (SEC).

PCAOB is doing the following:

1. Provides oversight for auditors of public companies.
 2. Establishes auditing and quality control standards for public company audits.
 3. Performs inspections of the quality controls at audit firms performing those audits.
- 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.

- PCAOB requires annual inspections of accounting firms that audit more than 100 issuers and inspections of other registered firms **at least once every 3 years.**
- **Any violations could result in disciplinary action by the PCAOB and be reported to the SEC and state accountancy boards.**

Summarize the role of the SEC in Accounting and Auditing

- It is 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 act of 1934 provides additional protection by requiring public companies and others to file detailed annual reports with the**

- The commission examines these statements for completeness and adequacy before permitting the company to sell its securities through the securities exchanges.
- The securities acts of 1933 & 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:**

1. Form S-1: These forms apply to the securities act of 1933 and must be completed and registered with the SEC when a Co. plans to issue new securities to the public. It is a general form used when there is no specifically prescribed form.
2. 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.

3. 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 CO. Extensive detailed financial information, including audited financial statements, is contained in this report.

4. 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.

- Most CPA firms have specialists who spend a large portion of their time ensuring that their clients satisfy all SEC requirements.
- SEC has considerable influence in setting GAAP and disclosure requirements for financial statements as a result of its authority for specifying reporting requirements considered necessary for fair disclosure to investors.
- 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 GAAP.

Describe the key functions performed by 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.
- AICPA membership is voluntary, so not all CPAs join.

- The AICPA is doing the following:
 1. Sets professional requirements for CPAs.
 2. Conducts research and publishes materials on many different subjects related to accounting, auditing, attestation and assurance services, management consulting services and taxes.
 3. Promotes the accounting profession through organizing national advertising campaigns.
 4. Promoting new assurance services.
 5. Developing specialist certifications to help market and ensure the quality of services in specialized practice areas.
 6. 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).
- 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

4. Code of Professional Conduct. The AICPA professional ethics executive committee sets rules of conduct that CPAs are required to meet.

OTHER AICPA FUNCTIONS:

- In addition to writing and grading the CPA examination, the AICPA performs many educational and other functions for CPAs. It also publishes a variety of materials, including journals.

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

Statements on Auditing Standards

- Classification of Statements on Auditing Standards
- GAAS and Standards of Performance

International Standards on Auditing

IFAC is the worldwide organization for the accountancy profession.

The IAASB works to improve the uniformity of auditing practices and related services throughout the world.

INTERNATIONAL AND 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:**

1. International Standards on Auditing (ISAs),
2. U.S. Generally Accepted Auditing Standards (GAAS) **OR** (AICPA auditing standards) for entities other than public companies, and
3. PCAOB (Public Company Accounting Oversight Board) Auditing Standards.

International Standards on Auditing (ISAs)

- They 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 159 member organizations in 124 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.
- Most countries, including the United States, base their auditing standards on ISAs, modified as appropriate for each country's regulatory environment and statutory (legal) requirements.
- Therefore, 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.

(AICPA) Auditing Standards OR (GAAS)

- 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)**.
- These Generally Accepted Auditing Standards (GAAS) 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 U.S. environment.

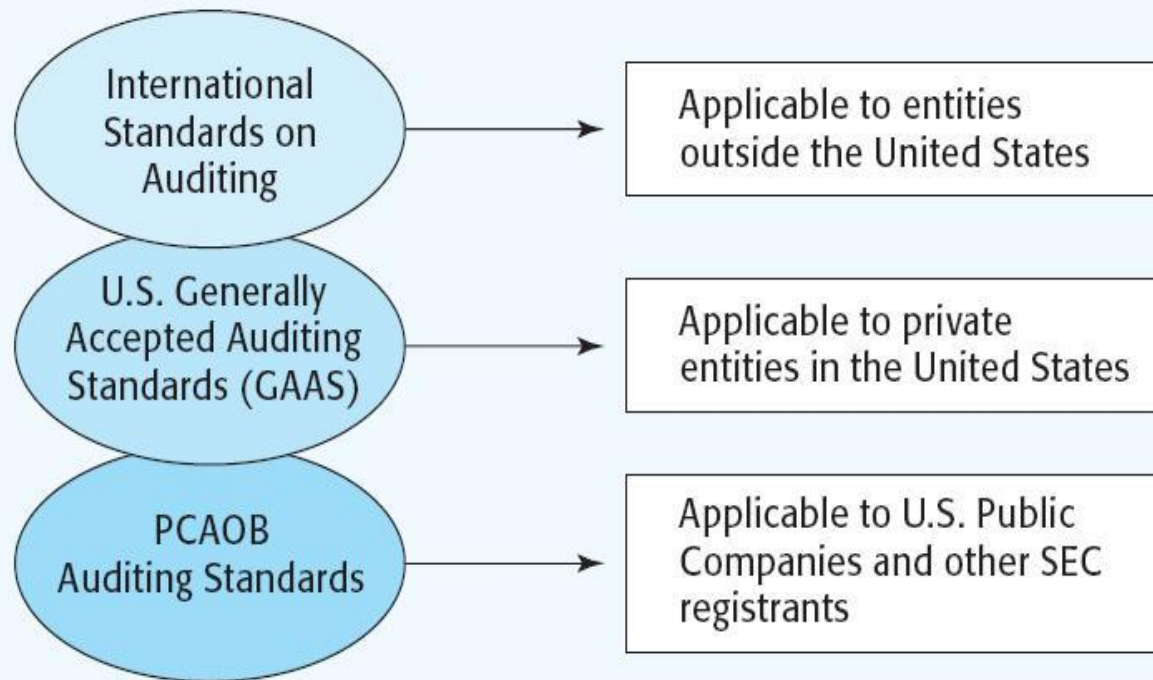
PCAOB Auditing Standards

- The PCAOB now has responsibility for auditing standards for U.S. **public companies**.
- 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 apply only to the audits of public companies.

International Standards on Auditing

FIGURE 2-1

Relation of U.S. and International Auditing Standards





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

GAAS

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.

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PCAOB Auditing Standards – United States

General Standards

1. Adequate training and proficiency
2. Independence in mental attitude
3. Due professional care

PCAOB Auditing Standards – United States

Standards of Field Work

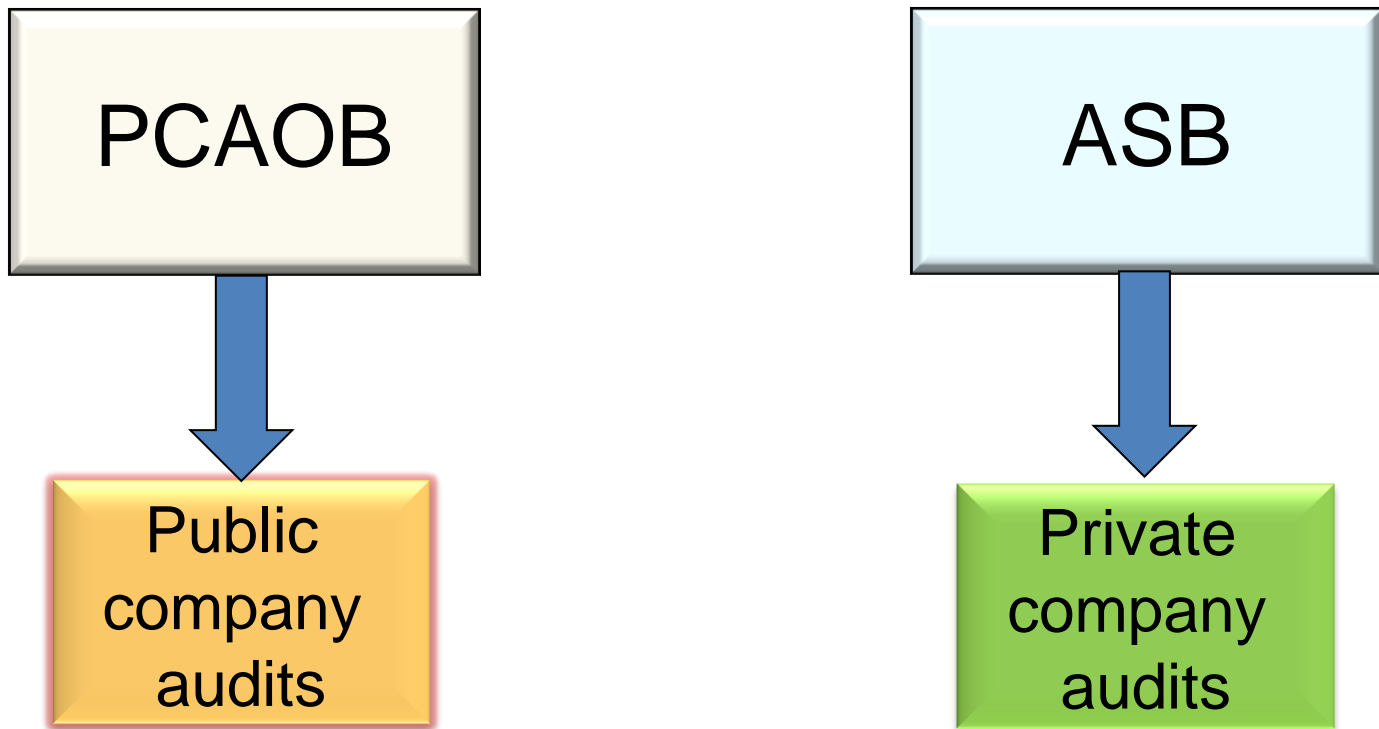
1. Proper planning and supervision
2. Understanding of the entity
3. Sufficient appropriate evidence

PCAOB Auditing Standards – United States

Standards of Reporting

1. Statements prepared in accordance with GAAP
2. Circumstances when GAAP not followed
3. Adequacy of disclosures
4. Expression of opinion on financial statements

Relationship Between ASB and PCAOB Auditing Standards



Statements on Auditing Standards

The 10 generally accepted auditing standards are too general to provide meaningful guidance.

SAS interpret the 10 generally accepted auditing standards and are the most authoritative references available to auditors.

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Identify quality control standards and practices within the accounting profession.

QUALITY CONTROL

- 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.

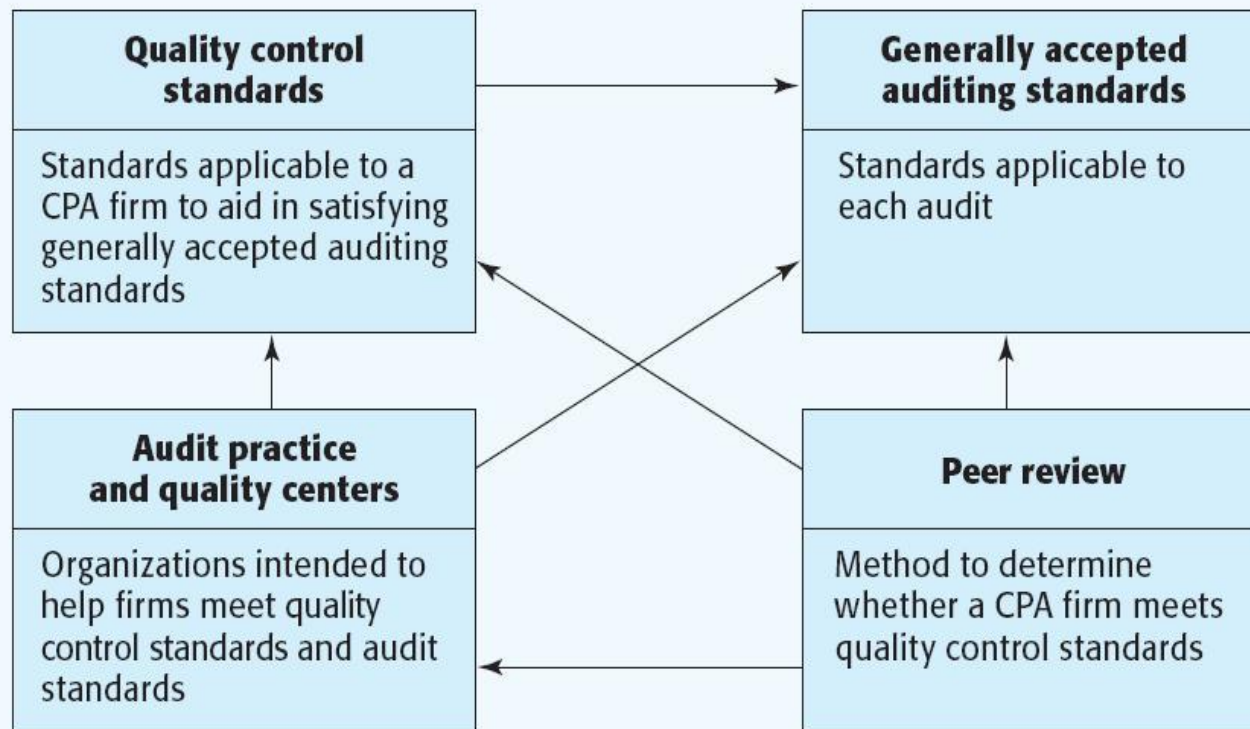
Elements of Quality Control

- Leadership responsibilities for quality
- Relevant ethical requirements
- Acceptance and continuation of clients and engagements
- Human resources
- Engagement performance
- Monitoring

Relationships

FIGURE 2-3

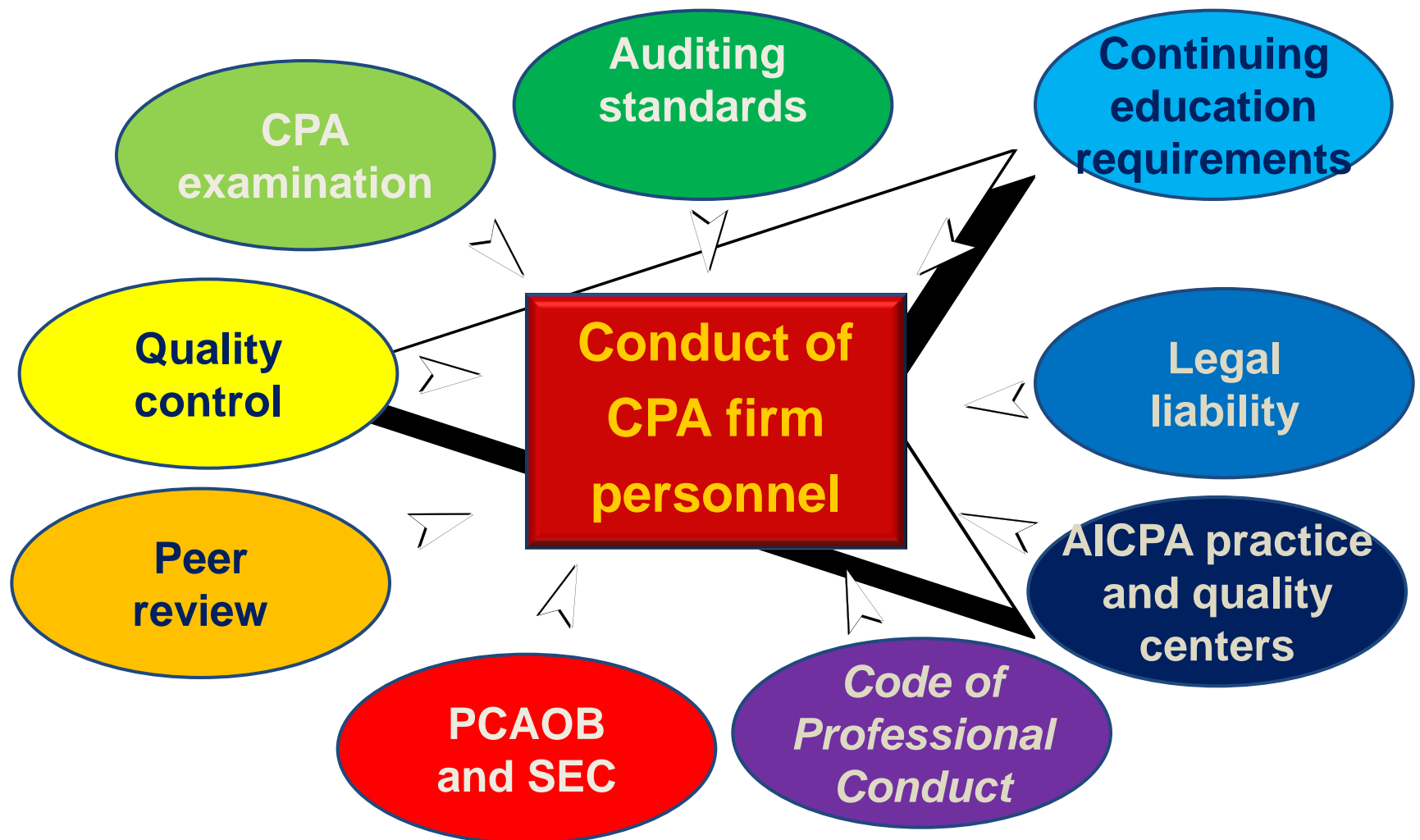
Relationships Among GAAS, Quality Control, AICPA Practice Centers, and Peer Review



Elements of Quality Control

TABLE 2-4 Elements of Quality Control		Example of a Procedure
Element	Summary of Requirements	
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	<p>Policies and procedures should be established to provide the firm with reasonable assurance that</p> <ul style="list-style-type: none"> • 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.

CPAs Encouraged to Conduct Themselves at a High Level



End of Chapter 2

