Auditing The Art and Science of Assurance Engagements (Canadian) 14th edition Arens Solutions Manual

SKU: 9780134613116-SOLUTIONS

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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.

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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.

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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 AICAPA 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.

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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.

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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.

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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.

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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.

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- 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.

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- 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.

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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

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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.

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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' 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.

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Chapter 2
The Public Accounting Profession and Audit Quality

Overview

It's best to start this lecture with a short review of Chapter 1. Remind students that the basic premise behind auditing is "checking". Keeping in mind that the vocabulary used in this course continues to be new for most students and that most have not actually done any audit work, we can say that this lecture is about organizations that set the rules for how audit work should be performed and about the qualities that must be possessed by individuals who conduct this work. Why is this important? Because the audit process gives users more confidence in the information presented on financial statements and it's this confidence that creates the value of the audit. This lecture is about how confidence in the audit process is created and protected.

Learning Objectives

1. Describe the public accounting industry.
2. Identify the organizations that affect the public accounting profession and their role.
3. Describe how the *CPA Canada Handbook—Assurance* is organized.
4. Use Canadian Auditing Standards to explain the purpose of and the principles underlying the financial audit.
5. Understand the drivers of audit quality and explain the competing pressures auditors face that threaten audit quality.
6. Identify quality control standards and practices within the auditing profession and apply those standards and practices to enhance audit quality.

Chapter Opening Vignette: "A Focus on Audit Quality"

This vignette highlights how the 2008-09 financial crisis reignited the debate over improving financial statement audit quality and how the IAASB has made audit quality central to its work plan. It then points out that the difficulty of assessing the quality of audits is that there is no agreed-upon definition or measurement of audit quality. The vignette concludes that, although in Canada the quality of public company audits is improving, one key area that remains a challenge is auditing in emerging markets. (A good question to ask the students is how they would define and measure audit quality, or how they would describe a "good quality" audit).

LO 1 An Overview of the Canadian Public Accounting Industry

Refer to Table 2-1 and Table 2-2 to present the difference in size between public accounting

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firms and how a typical firm is organized.



Teaching Tip: A good question to ask the students is if they are pursuing the CPA designation and if they are aware of university career events put on by Public Accounting Firms. This question can lead to an engaging discussion about why students are interested in working in the public accounting sector.

Students are usually interested in CPAs' salaries. The instructor may wish to show the results of Robert Half 2016 Salary Guide for Accounting and Finance professionals, which lists the salary ranges for accounting and finance professionals. The guide can be found at: https://www.roberthalf.ca/sites/roberthalf.ca/files/rh-pdfs/atfamr_0915_iapdf_sg2016_can_eng.pdf

Most students may not be familiar with the differences in the working environments of a large versus a small public accounting firm. Auditing in Action 2-1 as well as sharing your firm working experience can be useful to discuss this.



Teaching Tip: Most universities have accounting clubs/organizations. When preparing for this lecture, the instructor can prearrange a 5-10 minute presentation with the accounting club/organization. Topics for the presentation could include: upcoming career events, the role of the club/organization.

LO 2 Organizations Affecting the Canadian Public Accounting Profession

Review the key roles of organizations affecting the Canadian Public Accounting Profession. We should tell the students that:



Teaching Tip: Students would be interested in the educational and work experience requirements of a CPA. These can be found at **www.gocpaontario.ca**

CPA Canada: represents the CPA profession nationally and internationally; it plays a key role in audit quality. It supports the setting of accounting, auditing, and assurance standards for business, not-for-profit organizations, and government. Individual CPAs are not members of CPA Canada, but rather members of their provincial CPA organizations.

We can explain to students here that, in simple terms, standards are instructions about "how to do things." For instance, accounting standards describe how to define, record, and disclose information about economic events and transactions. Similarly, just like a cake recipe contains step-by-step instructions and a list of baking ingredients, auditing and assurance standards contain step-by- step instructions on how to conduct an audit. We can ask the students what would happen to the quality or taste of a cake if the steps in the recipe are not followed, or incorrect ingredients are used (most likely the cake would not taste good and would be of poor

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quality) and point out that audit quality can be impacted the same way (when the auditor fails to follow auditing and assurance standards).

Students may think of standards as rigid rules, with some thinking that these rules are seldom changed. We can point out here that, just like a new cake recipe can be created or updated to include new ingredients, standards are frequently developed and old ones are adapted to reflect changes in the "real-world." For example, we discuss how standards need to be adapted to "real world" developments, such as digital currencies like BitCoins.

After you have completed this discussion, briefly talk about the importance of:

- *Canada's Auditing and Assurance Standards Board (AASB):* has the authority to set generally accepted auditing standards (GAAS) for financial statement audits.
- *International Auditing and Assurance Standards Board (IAASB):* is an independent standard-setting body that sets international standards for auditing, assurance, and other related standards.



Teaching Tip: Auditing in Action 2-2 can be used to explaining to students the relationship between AASB and IAASB and how public interest plays a role in the standards setting process.

- *Canadian Public Accountability Board (CPAB)* and its practice inspection program is something that students may find interesting if we revolve the discussion around the following question. If the responsibility of the auditor is to audit, then who audits the auditor? The role of the CPAB mentioned in the opening vignette can be brought into this discussion.
- *Public Company Accounting Oversight Board (PCAOB)* is the US counterpart to CPAB. However, unlike CPAB, it also establishes auditing and quality control standards for public company audits.
- *Provincial Securities.* Mention that Securities regulation in Canada is a provincial matter. Many large Canadian companies, however, are listed on the American stock exchanges, and, therefore, must meet the requirements of the *Securities and Exchange Commission (SEC).*

LO 3, LO4 An Overview of CPA Canada Assurance Standards

All of the standards start from fundamental principles on how an audit engagement should be planned and conducted and then how the results should be communicated. Use Table 2-3 to provide an overview of the Assurance standards and introduce students to the *CPA Canada Handbook*. Students are usually confused by the terminology in Table 2-3, so to simplify things we can remind students that standards found in each *Handbook* section are simply instructions that describe how and what work the CPA should conduct.
We point out that Assurance standards make up a chapter of the *Handbook*, another one being "Accounting," something students should already be familiar with.
Questions below and Figure 2-1 can help with the discussion about the general requirements of the Financial Statement Audit. The key concept for students to understand is that audit enhances the users' confidence in the information presented in the financial statements.

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Confidence comes from the fact that financial information was checked by a competent, independent individual. We can relate this point to the mid-term exam example from session 1, and ask the students if they would feel more confident about the accuracy of their posted final exam grade if they knew that the grade posted online was checked by an independent and competent individual.

Purpose of the Audit:

- What do the numbers on the financial statements represent?
- Why are numbers on the financial statements checked?

Personal responsibilities of the auditor:

- What qualities should the Auditor possess that will give confidence to those that rely on the audit opinion?
- Why is that important?

Auditor actions in performing the audit:

- Would financial statement users be confident in the audit process if it was up to each individual auditor to decide how audit work is planned and performed?

Reporting:

- Why is it important to express an opinion on financial statements in writing?
- What happens when the wrong opinion is issued?
- How would this impact users' confidence in the audit process?
- How would students feel if later on they find out that their final exam grade that was posted online and was checked by the "auditor" was still, in fact, incorrect? Would they lose trust in the process?



Teaching Tip: Figure 2-2 is a good figure to use to highlight and explain the different sections of the Independent Auditor's Report.

LO 5 The Drivers of Audit Quality

We can discuss the events surrounding The World Com and Enron bankruptcies, as well as the 2008–09 financial crisis. Ask the students if they think these events would impact users' confidence in the audit profession. We can then explain to students that around the globe, several initiatives are underway to enhance audit quality to ensure users' remain confident in the audit profession and information presented on financial statements.
It is important to point out that Public Accounting Firms are in a constant struggle trying to maintain the appropriate balance between commercialism (managing the economic business of the firm) and professionalism (sustainable high-quality audits). This could be explained by discussing the following:

Time Pressures

CPA firms often compete for clients through bids. The low bidder is likely to get the job. But, in order to make a sufficient return on the audit, there will be time pressures to get the audit done as quickly as possible to minimize labour costs.

Rationalizing Behaviour

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When potential misstatements are detected, it takes time to investigate and determine if they could be material. To save money and time, the auditor may rationalize that the misstatement is not likely to be material, when in fact it could be.

Providing Nonaudit Services

CPAs may help non-public companies or other organizations improve their information system, suggest and help the client implement "best practices," do the client's bookkeeping, identify potential candidates for management positions, etc.
Independence is likely to be compromised if auditors are put into the position of auditing their own work, or if auditors identify too closely with the company as if it were an extension of their work.



Teaching Tip: Question 2-22 is a good question to use to highlight beliefs of some practitioners about quality control and practice inspections.

LO 6 Quality Control

Most students would not have actually performed any audit work and therefore they don't understand the audit process. Most will therefore struggle to understand what is meant by "quality control" policies and procedures within a Public Accounting firm. The concept of quality control can be demonstrated using the exercise from the previous lecture where students were asked to audit if all students that are currently sitting in the classroom are actually registered in the course. Except this time, we would discuss the quality control procedures over the audit work that was previously conducted. For instance, the following questions can be discussed as part of this exercise:

- Was the individual who conducted the work independent?
- What if the work was conducted by a close friend of a student who was not registered in the course but was sitting in the classroom?
- Was the audit work reviewed by someone else to ensure it was conducted completely and accurately by an independent individual?



Teaching Tip: Auditing in Action 2-3 can be used to explain the purpose of practice inspections and point out key findings from the 2016-17 round of inspections.



Instructors may wish to show this video

http://www.cpab-ccrc.ca/en/topics/AuditQualitySymposium/Pages/default.aspx

In November 2014, CPAB held its third Audit Quality Symposium convening Canadian and international directors, business leaders, policy makers, audit firm leaders, regulators and academics to discuss the changing expectations in the world of audit. This video presents comments of some of the participants who took part in the symposium.

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Lecture Review

This chapter discussed the nature of the public accounting profession and the activities of public accounting firms. Because public accounting firms play an important social role, several Canadian organizations provide oversight to increase the likelihood of appropriate audit quality and professional conduct.

How are public accounting firms organized? Small accounting firms are set up as sole proprietorships or partnerships. Most of these firms have fewer than 25 professionals in a single office. Many small local firms do not perform audits and primarily perform reviews and compilations along with accounting and tax services. Larger firms such as Deloitte Touche LLP, Pricewaterhouse Coopers LLP, KPMG LLP, and Ernst & Young LLP, are set up as limited liability partnerships. These international firms have offices throughout Canada and the world, and audit nearly all of the largest companies in Canada and worldwide and many smaller companies as well.

How do we ensure that the public remains confident in the audit profession? Completion of audits to high ethical standards helps maintain confidence in the audit profession.

What are quality control standards and how are they enforced? Quality controls are policies and procedures used by a public accounting firm to ensure that it fulfills its professional responsibilities. Practice inspections are conducted by the professional associations, the provincial institutes, and the CPAB.

Suggested Homework Problems

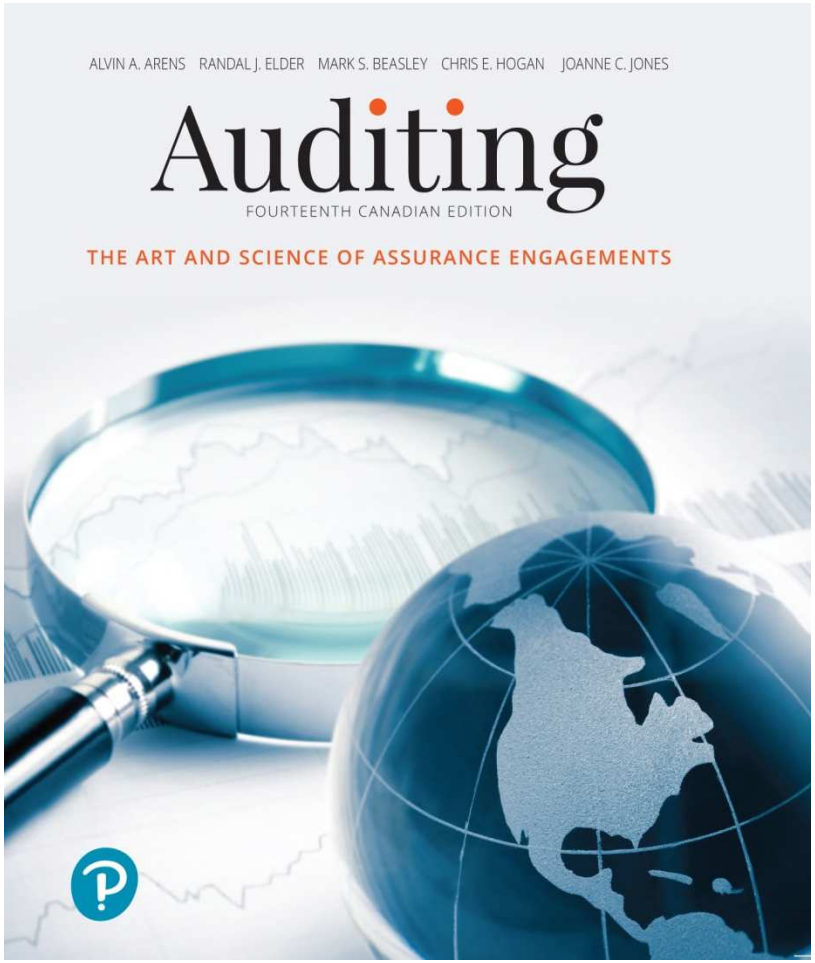
Learning Objectives	Review Questions	Multiple Choice Questions	Discussion Questions and Problems	Professional Judgment Problems and Cases
LO 1	2-1, 2-2, 2-3	2-17		
LO 2	2-4, 2-5, 2-6, 2-7, 2-8, 2-9	2-17		2-23
LO 3	2-5, 2-10,			
LO 4	2-10, 2-11, 2-12	2-18	2-20	2-23, 2-26
LO 5	2-13		2-22	2-24, 2-25, 2-27
LO 6	2-14, 2-15, 2-16	2-19	2-22	2-23, 2-24, 2-25, 2-27

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Auditing: The Art and Science of Assurance Engagements

Fourteenth Canadian Edition



Chapter 2

The Public Accounting Profession and Audit Quality

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Learning Objectives

1. Describe the public accounting industry.
2. Identify the organizations that affect the public accounting profession and their role.
3. Describe how the *CPA Canada Handbook—Assurance* is organized.
4. Use Canadian Auditing Standards to explain the purpose of and the principles underlying the financial audit.
5. Understand the drivers of audit quality and explain the competing pressures auditors face that threaten audit quality.
6. Identify quality control standards and practices within the auditing profession and apply those standards and practices to enhance audit quality.

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Public Accounting Firms

- There are more than 5,000 public accounting firms in Canada.
- These firms are usually broken into four categories:
  - Big four international firms;
  - National network firms,
  - Large local and regional firms and
  - Small local firms.

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Structure of Public Accounting Firms

- The **structure** of public accounting firms should foster independence, competence and mitigate litigation risk.
- The organizational form used by many public accounting firms is that of a sole proprietorship or a partnership. (Most provinces allow limited liability partnerships or professional corporations.)
- The organizational hierarchy in a typical public accounting firm includes partners, managers, supervisors, seniors or in-charge auditors, and assistants.

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Professional Accounting Firms: Staff Levels and Responsibilities

Table 2-2 Staff Levels and Responsibilities

Staff Level	Average Experience	Typical Responsibilities
Staff accountant	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	5-7 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.
Senior manager	7-10 years	Leads the engagement and reviews the team's work. Works directly with the partner and assists in client relationship.
Partner	10+ years	Leads the engagement, reviews the overall audit work, and is involved in significant audit decisions. A partner has the ultimate responsibility for conducting the audit and maintaining client relations.

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Organizations Affecting the Canadian Public Accounting Profession (1 of 2)

- CPA Canada
  - CPA Canada represents the CPA profession nationally and internationally
  - CPA Canada is the new umbrella organization for the CPA designation and provincial accounting bodies
  - CPA Canada standardizes uniform qualifications for admission of CPAs and developing the CPA Professional Education Program (CPA PEP) and the CPA Common Final Examination (CFE)
- Provincial CPA Organizations
  - maintain individual CPA memberships of CPAs

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Organizations Affecting the Canadian Public Accounting Profession (2 of 2)

- Auditing and Assurance Standards Board (AASB)
- International Auditing and Assurance Standards Board
- Canadian Public Accountability Board (CPAB)
- Public Company Accounting Oversight Board (PCAOB)
- Provincial Securities Commissions
- Securities and Exchange Commission (SEC)

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Overview of Generally Accepted Auditing Standards

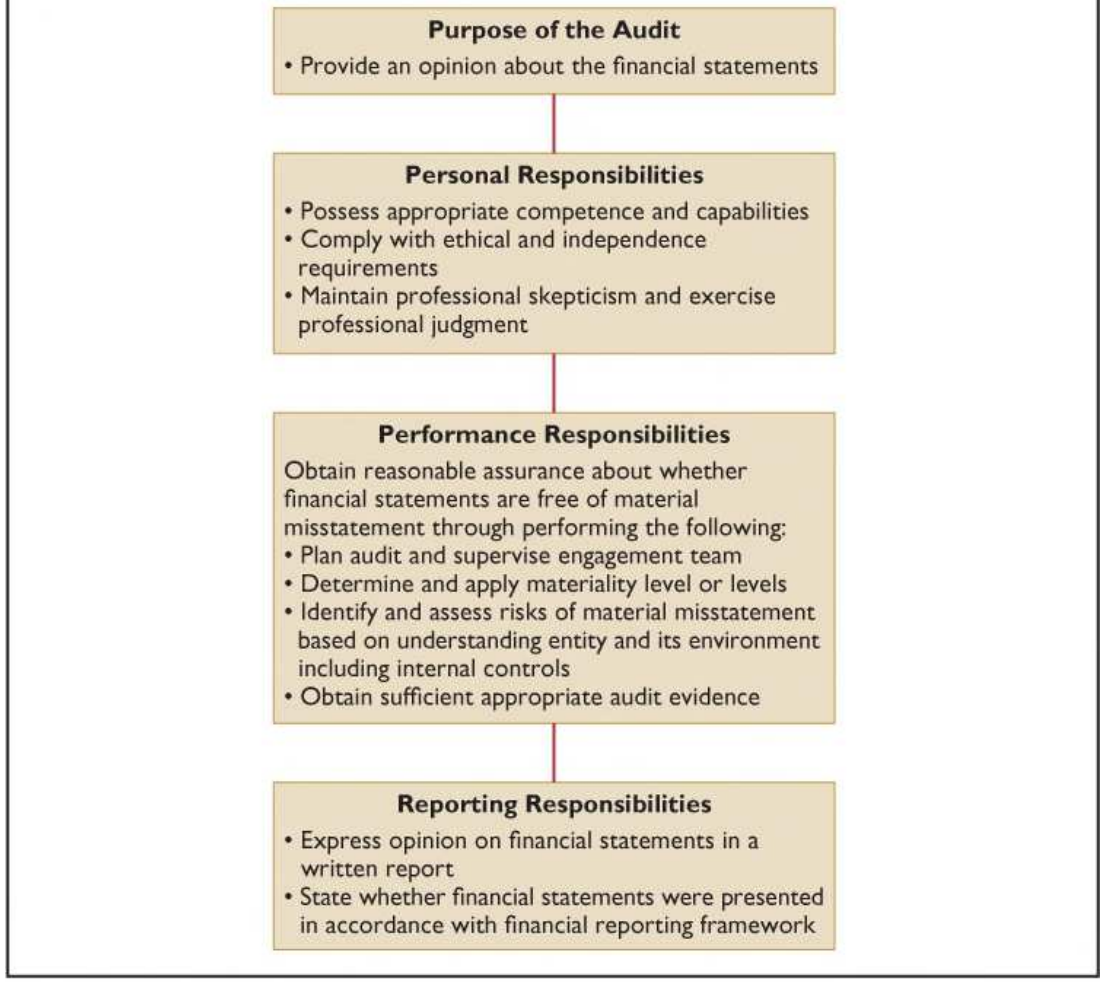
- Generally Accepted Auditing Standards (GAAS) are part of the "Assurance Handbook" in the *CPA Canada Handbook*. They are the standards for the financial statements audit.
- Canadian Auditing Standards (CAS) are based on ISAs developed internationally.
- See Table 2-4 for An Overview of Canadian Auditing Standards.

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General Requirements of F/S Audit

Figure 2-1 Principles Underlying the Financial Statement Audit



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Purpose of the Financial Statement Audit

- Purpose is to provide users with an opinion issued by auditor on fair presentation of financial statements, in all material respects, in accordance with applicable financial reporting framework.
- Financial statement preparation is the responsibility of management.
- Design, implementation and maintenance of internal controls is responsibility of management.
- CASs state auditor can conduct audit only if management acknowledges and understands their responsibilities and provides auditor unrestricted access.

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Auditors' Personal Responsibilities

- Professional Competence and Due Care
  - Formal education
  - Adequate practical experience for work being performed
  - Continuing professional education
- Compliance with Ethical and Independence Requirements:
  - Integrity, objectivity, confidentiality, professional behaviour
  - Independence is key-accounting firms required to follow practices to increase independence likelihood on audit engagements
- Professional Skepticism and Professional Judgement
  - Questioning mind, alert for possibility of misstatements

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Auditors' Performance Responsibilities

- Adequate Planning and Supervision
- Determining and Applying Materiality Levels
- Identify and Assess Risks of Material Misstatement
- Obtaining Sufficient and Appropriate Evidence
- Reporting

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Independent Auditor's Report Explained

Figure 2-2 The Auditor's Report Explained

INDEPENDENT AUDITOR'S REPORT

The report is addressed to the members or shareholders of the organization.

To the Shareholders of Hillsburg Hardware Limited:

This section sets out the basic details of the engagement—the applicable reporting period, name of company, and what was audited.

Opinion

We have audited the accompanying financial statements of Hillsburg Hardware Limited, which comprise the balance sheet as at December 31, 2018, the statements of earning and surplus and cash flows for the year ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

The auditor sets out his or her overall finding in an opinion and the applicable accounting framework (ASPE). This is an example of an unmodified or "clean" audit opinion.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of Hillsburg Hardware Limited as at December 31, 2018, and the results of operations and its cash flows for the year then ended in accordance with Canadian accounting standards for private enterprises.

The auditor explains the basis of conclusion—have conducted audit in accordance with Canadian GAAS and obtained sufficient and appropriate audit evidence. Also informs readers that auditor is independent and in compliance with ethical requirements.

Basis for opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for preparing the financial statements according to applicable accounting framework (in this case ASPE), for internal controls in the company, and for assessing the going concern assumption.

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian accounting standards for private enterprises, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to the going concern using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Highlights those charged with governance responsibility.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

(continued)

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Figure 2-2 *(Continued)*

Responsibilities for the Audit of Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue the auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with Canadian generally accepted audit standards, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

This section provides an overview of the objective of the audit, explains the concepts of reasonable assurance and materiality, and provides details of the auditor's responsibilities. The last paragraph highlights the auditor's reporting responsibilities to those charged with governance (the audit committee or the board of directors) of Hillsburg.

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; design and perform audit procedures responsive to those risks; and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events and conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements, or if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Entity to cease to continue as a going concern.
- Evaluate the overall presentation, structure, and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transaction and events in a manner that achieves fair presentations.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any deficiencies in internal control that we identify during the audit.

[signature of]
Boritz, Kao, Kadous & Co., Ltd.
March 1, 2019
Halifax, Nova Scotia

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Improving Audit Quality

- The CPAB recommends that firms can improve audit quality by focusing on four key areas:
  - Build the right teams (technical competence and industry experience)
  - Provide the right support (open environment)
  - Conduct in-process reviews (throughout audit, not when completed)
  - Assign accountability for audit quality (to those who are specifically assigned this responsibility)
- Metrics should be developed to measure audit quality.

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Quality Control (1 of 3)

- **Quality control** comprises the methods used to make sure that the firm meets its professional responsibilities to clients.
- These methods include the organizational structure of the public accounting firm and the procedures the firm sets up.
- Quality controls are used by the firm to make sure it meets Canadian Auditing Standards consistently on every engagement.

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Quality Control (2 of 3)

- CPA Canada Handbook section CSQC-1 describes the general standards of quality control that are applied to firms performing assurance engagements.
- These standards set out the minimum policies and procedures that firms should have in place.
- Refer to Table 2-5 for a listing of quality control elements.
- CASs are applicable to individual engagements; quality controls are established for the entire firm.

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Quality Control (3 of 3)

- CAS 220 deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements, and where applicable, the responsibilities of the engagement quality control reviewer.

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Elements of Quality Control (1 of 3)

1. **Leadership** responsibilities for quality within the firm: an organizational culture that promotes audit quality.
2. General **ethical** requirements: independence in fact and appearance; integrity and objectivity in performance.
3. **Independence**: develop, communicate and monitor policies and procedures to ensure that the firm complies with the independence guidelines.

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Elements of Quality Control (2 of 3)

4. Client **acceptance** and **continuance**: document annual risk assessment processes, including evaluation of a client's management integrity and auditor competence and independence.
5. General **human resource** policies: have adequate hiring policies that ensure competence, appropriate training, continuing professional development and promotion subject to ability to fulfill assigned responsibilities.

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Elements of Quality Control (3 of 3)

6. Engagement **performance**: have adequate policies and procedures to ensure that the work meets professional standards, regulatory requirements and firm quality standards
7. **Monitoring** of policies and procedures to ensure other quality control elements are being effectively applied.

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External Inspection

- Practice inspections done by provincial CPA organizations to ensure adherence to professional standards in the *CPA Canada Handbook*.
- Normally completed every three years.
- Beneficial both to profession (higher quality audits) and practitioner (improved firm practices).

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