Principles of Auditing and Other Assurance Services - 2024 Release 1st edition Whittington Solutions Manual

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CHAPTER 1

The Role of the Public Accountant in the American Economy

Review Questions

1-1 The "crisis of credibility" largely arose from the number of companies that restated their previously issued financial statements as a result of accounting irregularities and fraud. Especially responsible were the very visible Enron and WorldCom fraud cases. Both companies filed for bankruptcy and constituted the largest companies in American history to do so. The extent of the accounting irregularities and fraud being investigated and disclosed brought into question the effectiveness of financial statement audits. In addition, the criminal conviction of Arthur Andersen, LLP, one of the then Big 5 accounting firms, on charges of destroying documents related to the Enron case brought into question the ethics standards of the profession.

1-2 Assurance services are professional services that enhance the quality of information, or its context, for decision-making. The two types are: (a) those that increase the reliability of information and (b) those that involve putting information in a form or context that facilitates decision-making.

1-3 A financial statement audit is, by far, the most common type of attest engagement. The overall assertion, made by management, most frequently is that the financial statements follow generally accepted accounting principles.

1-4 A large corporation with securities listed on a stock exchange is required by the rules of the stock exchange and by the rules of the Securities and Exchange Commission to provide an audit report with the annual financial statements furnished to its stockholders. It also is required to engage the auditors to provide an opinion on its internal control. Apart from legal requirements, however, a large listed corporation recognizes that it must maintain investor confidence in the reliability of its financial statements and internal control over financial reporting if it is to continue to be able to secure capital from the public. The report by a firm of certified public accountants adds credibility to the financial statements prepared by the corporation. When a small family-owned enterprise elects to have an audit, the purpose usually is to use the auditors' report to support an application for a bank loan.

1-5 A report by an independent public accountant concerning the fairness of a company's financial statements is commonly required in the following situations:

(1) Application for a bank loan.
(2) Establishing credit for purchase of merchandise, equipment, or other assets.

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(3) Reporting operating results, financial position, and cash flows to absentee owners (stockholders or partners).
(4) Issuance of securities by a corporation.
(5) Annual financial statements by a corporation with securities listed on a stock exchange or traded over the counter.
(6) Sale of an ongoing business.
(7) Termination of a partnership.

1-6 To add credibility to financial statements is to increase the likelihood that they have been prepared following the appropriate criteria, usually generally accepted accounting principles. As such, an increase in credibility results in financial statements that can be believed and relied upon by third parties.

1-7 Business risk is the risk that the investment will be impaired because a company invested in is unable to meet its financial obligations due to economic conditions or poor management decisions. Information risk is the risk that the information used to assess business risk is not accurate. Auditors can directly reduce information risk, but have only limited effect on business risk.

1-8 At the beginning of the century, the principal objective of auditing was the prevention and detection of fraud. Audit work centered on the balance sheet, because the income statement was regarded as highly confidential and not for public disclosure. Today, the principal objective of auditing is to form an opinion on the fairness of financial statements and their conformity with generally accepted accounting principles. But the professional standards also require that an audit be designed to provide reasonable assurance of detecting material misstatements, due to errors or fraud. Particular emphasis is placed on the income statement which is of great importance to investors. Auditing today also has the objectives of meeting the requirements of the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board for public companies.

1-9 The statement is incorrect. The increasing integrated databases of today, along with available audit procedures make audited entire populations a possibility in many situations.

1-10 An operational audit attempts to measure the effectiveness and efficiency of a specific unit of an organization. It involves more subjective judgments than a compliance audit or an audit of financial statements because the criteria of effectiveness and efficiency of departmental performance are not as clearly established as are many laws and regulations or generally accepted accounting principles. The report prepared after completion of an operational audit is usually directed to management of the organization in which the audit work was done.

1-11 A compliance audit is an audit to determine whether financial reports or other assertions are in compliance with established criteria. The necessary ingredients are verifiable data and the existence of standards established by an authoritative body. An operational audit, on the other hand, is a review of a department or other unit of a business or governmental organization to measure the effectiveness and efficiency of operations. Internal auditors often perform operational audits as do auditors employed by the Government Accountability Office (GAO) of the federal government.

1-12 Internal auditors must be independent of the department heads and other line executives whose work they review. However, internal auditors are not independent in the same sense as a public accounting firm. The public accounting firm serves many clients and the revenue obtained from any one client is only a small part of the revenue of the firm. Internal auditors, on the other hand, are employees of one company, and are subject to the restraints inherent in the employer-employee relationship. Internal auditors can achieve a great deal of independence by reporting to the audit committee of the board of directors, but they cannot achieve the same degree of independence as is possessed by the external public accounting firm.

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1-13 The internal auditors are employees of Spacecraft, Inc., and may be influenced by corporate management. The public accounting firm is independent of the company and is in a better position to take positions opposed to those of company management. The work of the internal audit staff emphasizes measurement of the efficiency and effectiveness of various operating units of the company and compliance with all types of controls, whereas the public accounting firm is primarily concerned with determining the fairness of Spacecraft's financial statements.

1-14 The Government Accountability Office (GAO) is a staff of professional auditors which reports to Congress. Its function is to determine that programs carried out by federal agencies conform to the financial authorization of the Congress. It is also concerned with the cost-effectiveness of government programs. The audit activities include investigation of the costs and performance of corporations holding government contracts.

1-15 Among the many important contributions to auditing literature by the AICPA are the series of Statements on Auditing Standards (SASs), Statements on Standards for Attestation Engagements (SSAEs), Industry Audit and Accounting Guides, Audit Guides, Audit Risk Alerts, Statements on Standards for Accounting and Review Services (SSARSs), , and the Code of Professional Conduct (only two required).

1-16 A peer review is a critical review of a public accounting firm's practices by another public accounting firm (or other CPAs functioning as a peer review team). The purpose of a peer review is to encourage adherence to quality management standards established by the accounting firm and the profession.

1-17 The Securities and Exchange Commission (SEC) is an agency of the federal government and is responsible for administering a number of acts, including the Securities Act of 1933 and the Securities Exchange Act of 1934. In meeting this responsibility, the SEC reviews financial statements of companies offering securities for sale to the public. It is particularly concerned with requiring full disclosure of financial information and with preventing misrepresentation. Through the Public Company Accounting Oversight Board, the SEC now oversees public accounting firms that audit public companies. Included in this oversight process includes development of auditing, independence, and quality management standards; inspection of performance; and enforcement of the standards.

The AICPA is the national organization of certified public accountants. It has long been a leader in accounting and auditing research, in publication of authoritative accounting and auditing pronouncements and studies, and in promoting high professional standards of practice.

1-18 Services offered by public accounting firms in addition to auditing include other forms of attestation, tax work, consulting services, litigation support services, fraud investigation services, personal financial planning and accounting services. This last category includes preparation of financial statements for smaller companies that have limited accounting personnel and various types of write-up work. Public accounting firms also perform a variety of other services. Consulting services include aiding clients in the design of accounting systems, conversion to Information Technology (IT) systems, preparation of budgets, planning business combinations with other companies, executive search, and numerous other projects. Public accounting firms are restricted as to the consulting services that they may provide to audit clients, especially those that are public companies.

1-19 The partnership form of organization for a public accounting firm offers several advantages over a sole proprietorship. A partnership offers the opportunity for specialization by the partners in areas such as taxation, auditing, and consulting services. Partners can discuss difficult technical problems among themselves, and benefit from different perspectives. Also, the partnership may be better able

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to attract and retain high quality professional staff, because they may be rewarded by acceptance into the partnership.

1-20 The following characteristics of a professional corporation distinguish it from the traditional corporation:

(1) All shareholders must be engaged in the practice of public accounting.
(2) To the extent possible, directors and officers should be certified public accountants.
(3) Shares of a professional corporation may be transferred only to those engaged in public accounting or to the corporation itself.
(4) The corporation's shareholders and employees have liability equivalent to other forms of organizations (i.e., the corporate form of organization does not reduce liability). Note, however, that CPAs may choose to purchase liability insurance to limit potential liability.

1-21 Local firms usually have only one or two offices, are headed by a single CPA or have a few CPAs as partners, and serve clients in a single city or area. The services provided are mostly income tax work, consulting services, and accounting services. Auditing is often only a small part of the practice.

Regional firms often arise from the merger and expansion of local firms. They typically maintain several offices in neighboring cities and states. Auditing is a more important function for regional firms than for the local firms, because larger businesses are included among the clients.

National firms have offices in most major cities in the United States and some operate in other countries as well. These firms offer a full range of services, with auditing often representing the largest single portion of the practice.

International firms have offices in most of the world's major cities. These firms offer a full range of services, with auditing often representing the largest single portion of the practice.

1-22 The various levels of accounting personnel in a large public accounting firm are staff auditors, senior auditors, managers or supervisors, and partners (and principals).

The staff auditor performs audit procedures such as the observation of physical inventories and confirmation of receivables under the supervision of a senior. The senior auditor plans and coordinates the audit and drafts the audit report. The senior also reviews working papers, controls the allocation of audit time, and trains assistants on the job. The manager or supervisor usually is responsible for supervising and reviewing several audit engagements concurrently, and resolving significant problems with the client. The partners maintain contacts with clients, develop new business, establish policies of the firm, review the adequacy of audit work, and sign audit reports. The engagement partner is responsible for performance of the audit in accordance with professional standards. A partner also devotes time to the recruitment and development of staff, to AICPA and other professional group activities, to educational and other civic activities, and generally to promoting an environment in which the firm can prosper. The position of principal, which is often held by top-ranking consulting personnel who do not hold the CPA certificate, has responsibilities similar to those of a partner.

1-23 The most significant responsibilities of a partner in a public accounting firm include (only three required:

- Assume ultimate responsibility for the audits assigned to him or her
- Sign audit reports
- Review the audit work for compliance with firm and professional standards

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- Maintain relations with audit clients
- Establishing firm policies
- Staff recruitment and development

1-24 An accounting association becomes an accounting network when member firms share one or more of the following with other member firms: (1) common brand name; (2) common control; (3) profits; (4) common business strategy; (5) significant professional resources; (6) common quality management policies and procedures.

1-25 The International Auditing and Assurance Standards Board establishes *International Standards on Auditing* (*ISAs*) *International Standards on Quality Management* (*ISQM*) and standards for other assurance and related services. Its pronouncements are meant to foster the development of consistent worldwide professional standards. Its standards do not to override the national auditing standards of its members.

Questions Requiring Analysis

1-26 (a) The Sarbanes-Oxley Act of 2002 made significant reforms in the regulation system for public accounting firms that audit public companies. It contains provisions toughening penalties for corporate fraud, restricting the types of consulting CPAs may perform for audit clients, and creating the Public Company Accounting Oversight Board (PCAOB) to oversee the accounting profession.

(b) Primary regulation of public accounting firms that audit public companies is provided by the PCAOB and the Securities and Exchange Commission (SEC). With respect to the practices of these firms, the PCAOB has the responsibility for:

(1) Establishing or adopting auditing, quality management, and ethics standards,
(2) Registering public accounting firms,
(3) Performing inspections of the practices of registered,
(4) Conducting investigations and disciplinary proceedings of registered firms, and
(5) Sanctioning registered firms.

The SEC investigates violations of the securities laws, including allegations of fraudulent financial reporting and public accounting firm audit deficiencies. In addition, the state boards of accountancy may revoke any public accounting firm's license to practice.

(c) Primary regulation of public accounting firms that are not under the PCAOB's inspection program rests with the AICPA and the state boards of accountancy. Members of the AICPA in public practice must practice with a firm that participates in a practice review program. Firms can meet this requirement by enrolling the AICPA Peer Review Program, which requires the firm to have a peer review every 3 1/2 years. Ethical violations are investigated and enforced by the AICPA and the state boards of accountancy.

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1-27 (a) Audits of financial statements of a corporation contemplating issuing debenture bonds may facilitate the transaction through reducing information risk—the risk that the information used to make the investment decision is materially misstated. Misstatements of the financial statements may occur due to accidental errors, lack of knowledge of accounting principles, unintentional bias, or by deliberate falsification of the statements.

(b) When financial statements have not been audited a "credibility gap" may exist in that management can hardly be expected to be impartial and unbiased in their preparation. This credibility gap may lead to a situation in which investors find the information risk too great and they decide not to invest in the bonds. If they do decide to invest in the bonds, the investors will likely demand a higher rate of return.

1-28 The Public Company Accounting Oversight Board was created because of the concerns about the credibility of the public accounting profession that occurred in the later part of 2001 and the early part of 2002. The large number of public company restatements due to accounting irregularities and fraud caused the investing public and Congress to question the effectiveness of audits. In addition, the conviction of Arthur Andersen LLP of destruction of evidence related to the Enron case caused Congress to question the profession's ethical principles. The Public Company Accounting Oversight Board has the responsibility to oversee and discipline public accounting firms that audit public companies. Specifically, the PCAOB has the responsibility for:

(1) Establishing or adopting auditing, quality management, and ethics standards,
(2) Registering public accounting firms,
(3) Performing inspections of the practices of registered,
(4) Conducting investigations and disciplinary proceedings of registered firms, and
(5) Sanctioning registered firms.

1-29 (a) An example of possible bias on the part of the provider of financial information is the situation in which an individual or business entity applies for a bank loan. In such circumstances, there is an incentive to overstate assets, income, and owner's equity, and to overlook or minimize liabilities. Distortions of this type give the appearance of greater financial strength.

(b) A bank loan officer may insist that a prospective borrower provide audited financial statements. This provides assurance that the data in the financial statements have been examined by independent competent persons.

1-30 The AICPA currently develops independence and ethical standards, quality management standards, and auditing and attestation standards that apply to its members. However, AICPA standards are applicable to the audits and auditors of nonpublic clients based on general acceptance by the courts, and adoption by state boards of accountancy and other regulatory bodies. The AICPA also has a peer review program, and enforces its standards on its members.

The PCAOB was given the legal authority to develop independence and ethical standards, quality control standards, and auditing and attestation standards that apply to public company auditors and integrated audits. The PCAOB also is charged with performing inspections of registered audit firms, and may sanction the firms for noncompliance with its standards and the provisions of the Sarbanes-Oxley Act.

The state boards of accountancy regulate CPA firms and CPAs in the various states and jurisdictions. They have the authority to establish their own standards, but have generally adopted the standards of other bodies such as the AICPA and the PCAOB. A state board enforces its standards in its state or

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jurisdiction and has the authority to revoke a CPA firm's or individual CPA's right to practice in the state.

Objective Questions

Multiple Choice Questions

1-31 (a) (3) Both sets of standards require independence.

(b) (1) The client's management is primarily responsible for representations contained in the financial statements. The independent auditors are responsible for performing their audit in accordance with generally accepted auditing standards.

(c) (1) The most important benefit of having an annual audit by a public accounting firm is to provide assurance to investors and other outsiders that the financial statements are dependable. The expansion of the securities markets has tremendously increased the need for verification of financial statements performed by competent, independent persons. Answer (2) is incorrect because management cannot avoid responsibility for the financial statements by retaining independent auditors. Answer (3) gives no recognition to the fact that many nonpublic corporations and other business entities have no obligation to file audited financial statements with governmental agencies. It also disregards the fact that large corporations which secure capital from the general public would continue to provide audited statements even though there were no such requirements by governmental agencies. Answer (4) is unacceptable because it implies that an audit is designed to detect illegal acts without regard to type or size.

(d) (2) The PCAOB ordinarily does not review financial reports filed with the Securities and Exchange Commission—although, if they so desire, they may review such reports to accomplish their other responsibilities. The other three replies are all explicit responsibilities of the PCAOB.

(e) (4) The Public Company Accounting Oversight Board was given the authority by the Sarbanes-Oxley Act of 2002 to establish or adopt auditing standards for audits of public companies.

(f) (4) Governmental auditing often extends to audits of efficiency, effectiveness, and compliance (with laws, regulations, etc.). The other responses, adequacy, evaluation, and accuracy, are terms not typically used to summarize the scope of governmental auditing.

(g) (3) Normally, the higher in an organization an internal auditor reports, the greater the degree of independence. Accordingly, reporting to the audit committee of the board of directors increases the likelihood that the internal auditor will be able to act independently of those being audited. Answers (1) and (2) may lead to a lesser degree of independence because when an internal auditor reports to the financial vice-president or the controller they cannot objectively review their work. Answer (4) is incorrect because it is generally not practical or effective for the internal auditor to report to stockholders on a timely basis.

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(h) (4) Ethical scandals at the AICPA was not one of the causes of the passage of the Sarbanes-Oxley Act of 2002. All of the other responses contributed to passage of the Act.

(i) (3) The Federal Accounting Standards Advisory Board establishes accounting standards for United States governmental agencies. The Governmental Accounting Standards Board establishes accounting standards for state and local government entities.

(j) (4) Forensic audits are usually performed when fraud has been found or is suspected. Answer (1) is incorrect because it overstates the nature of most audits by suggesting that all audits are forensic in nature. Answer (2) is wrong in that CPA firms (or law firms) may perform forensic audits. Answer (3) is incorrect because while compliance audits may find fraud, they are not directed at fraud as are forensic audits.

(k) (1) Because the auditors' purposes for considering internal control are to (a) plan the audit and (b) to determine the nature, timing, and extent of the tests to be performed, answer (1) is correct.

(l) (2) A compliance audit measures the compliance of an organization with established criteria such as laws and regulations. Answer (2) is correct because it addresses policies and procedures on environmental laws and regulations.

1-32 (1) <u>Phrases more applicable to an audit performed in 1900:</u>

(a) Complete review of all transactions.
(c) Auditors' attention concentrated on balance sheet.
(f) Auditing procedures to prevent or detect fraud on the part of all employees and managers.
(l) Bankers and short-term creditors as principal users of audit reports.

(2) <u>Phrases more applicable to an audit performed today:</u>

(b) Assessment of internal control.
(d) Emphasis upon use of sampling techniques.
(e) Determination of fairness of financial statements.
(g) Registration statement.
(h) Fairness of reported earnings per share.
(i) Influence of stock exchanges and the investing public upon the use of independent auditors.
(j) Concern about fraudulent financial reporting.
(k) Generally accepted auditing standards.
(m) Pressure for more disclosure.
(n) Auditing for compliance with laws and regulations.

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1-33

Publication	Sponsor
1. Statements on Auditing Standards (SASs)	c. AICPA
2. The Journal of Accountancy	c. AICPA
3. Regulation S-X	b. SEC
4. Statements on Standards for Accounting and Review Services (SSARS)	c. AICPA
5. Financial Reporting Releases (FRRs)	b. SEC
6. Accounting and Reporting Standards for Corporate Financial Statements	d. FASB
7. Accounting and Reporting Standards for Governmental Entities	g. GASB
8. Industry Accounting and Auditing Guides	c. AICPA
9. Audit Risk Alerts	c. AICPA
10. The Tax Advisor	c. AICPA
11. Auditing Standards	h. PCAOB

1-34 Definitions

Column One	Column Two
1. Quality management	e. Peer Review
2. Operational audit	h. Measurement of effectiveness and efficiency of a unit of an organization
3. Internal control	i. Basis for sampling and testing
4. General Accountability Office	j. Auditing staff reporting to Congress
5. Disclosure	c. Material information
6. Critical characteristic that must be maintained by the accounting profession	d. Credibility
7. Public Company Accounting Oversight Board	a. Regulation of auditors of public companies
8. Securities and Exchange Commission	f. Registration statement
9. Audited financial Statements	b. Opinion
10. Compilation of financial statements	g. Accounting service

1-35

Statement	Type of Engagement
a. When financial statements are involved this is referred to as an audit.	E
b. The term “we are not aware of any material modifications that should be made” is often included in the report.	R
c. The report issued provides a summary of procedures followed and findings.	A
d. The report issued provides “reasonable assurance.”	E
e. The procedures involved are generally limited to inquiry and analytical procedures.	R
f. The report issued provides “absolute assurance.”	N
g. The report provides “limited assurance.”	R
h. The procedures followed are agreed upon with the specified user or users.	A
i. This type of engagement provides more assurance than a review.	E
j. The CPA need not be independent to perform this service.	N

1-36 Definitions

a. 1 Agreed-upon procedures engagement
b. 9 Review
c. 3 Attest engagement
d. 4 Audit of financial statements
e. 7 Integrated audit
f. 2 Assurance services
g. 6 Examination

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1-37 Definitions

a.	8	Securities and Exchange Commission
b.	2	Assertion
c.	9	Statements on Auditing Standards
d.	4	Financial reporting framework.
e.	7	Sarbanes-Oxley Act of 2002
f.	6	Public Company Accounting Oversight Board
g.	1	American Institute of Certified Public Accountants
h.	11	Suitable criteria.

1-38

Topic	Type of Auditor	Class of Work
1	CPA	Audit of financial statements
2	CPA	Audit of financial statements
3	Internal auditor	Operational audit
4	GAO	Operational audit
5	Bank examiner	Compliance audit
6	CPA	Consulting services
7	CPA	Audit of financial statements
8	Internal auditor	Operational audit
9	IRS	Compliance audit
10	CPA	Compliance audit
11	GAO	Compliance audit
12	CPA	Accounting services

Problems

1-39 SOLUTION: Feller Company (estimated time: 20 minutes)

(a) Farber should explain to Feller that an independent audit is an examination of the financial statements in accordance with generally accepted auditing standards. The objective of an audit is to render an opinion on the fairness with which the financial statements present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. The CPA, after an objective evidence-gathering audit, expresses an opinion on the fair presentation of financial statements. An independent expert is needed to lend credibility to the financial statements. It would not be meaningful for a company to report on itself without the attestation of an independent party because the company itself might not be objective.

(b) Farber should inform Feller of the following ways in which an independent audit can be beneficial to (only five required):

(1) Serve as a basis for the extension of credit.
(2) Supply credit rating agencies with required information.
(3) Serve as a basis for preparation of tax returns.
(4) Establish amounts of losses from fire, theft, burglary, and so forth.
(5) Determine amounts receivable or payable under various agreements.
(6) Provide data for possible sale or merger.
(7) Serve as a basis for action in bankruptcy and insolvency cases.
(8) Determine proper execution of trust agreements.

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(9) Furnish estates with information to obtain proper settlements and avoid costly litigation.
(10) Improve internal control.
(11) Provide aid in cases of tax audits, court actions, and so forth.
(12) Discourage employees from perpetrating errors and fraud.
(13) Provide industry-wide comparisons.
(14) Assist in analysis of adequacy of insurance coverage.
(15) Provide the professional knowledge of an external auditor, which may help company in a number of ways.

1-40 SOLUTION: Peters & Ferrel (Estimated time: 20 minutes)

Peters is taking a very narrow view of the CPA's role in the American economy. The reserved, aloof attitude recommended by Peters was perhaps justified a half-century or more ago when the primary objective of many audits was the discovery of errors, defalcations, and other forms of fraud.

In the current era, the auditors' role has changed from that of a "detective" to that of accounting experts whose breadth of experience in the audit of many companies enables them to offer clients constructive advice which leads to compliance with accounting principles, improved accounting methods, better financial administration, and more profitable operation.

To fulfill this broader role of advisers as well as impartial reviewers, the auditors need the cooperation of client personnel at all levels. They need managers and employees to speak freely of their problems and to explain fully why certain operating methods are followed. The audit will be far more effective if client personnel are willing to identify problem areas. This kind of two-way communication between the client and the auditors will be possible only if the client views the auditors as approachable, cordial individuals with a sincere interest in helping the client.

The auditors can be independent and objective without being cold and impersonal. They should never convey the impression that they regard the client's employees as potential embezzlers. Neither should they take over office equipment or accounting records in a manner that suggests lack of consideration for the convenience and status of the client's staff.

The development of social relationships with the client outside the office, as advocated by Ferrel, is helpful to the CPA partner as it is to the architect, the physician, the attorney, and members of other professions. The successful CPA will usually be an active community leader, well known in civic organizations, social clubs, educational circles, and many other related areas. The CPA not only attracts new clients but contributes to the advancement of the total environment in which the CPA's professional talents are employed.

The most difficult issue posed by Peters and Ferrel is whether the development of very close friendships between the CPA and staff on the one side and the client and staff on the other may cause the CPA to lose independence to some degree. This possibility cannot be easily dismissed. In assessing relationships with the client, the CPA must not only consider the fact of being independent, but also the recognition of independence by the public. The CPA must ask the question: Would an outsider having full knowledge of the relationships between the CPA and a client have doubts about the CPA's independence?

This hard-to-define narrow path between cordial CPA-client relations on the one hand and the threat of loss of public confidence in the CPA's independence on the other demands that the CPA exercise care and judgment in social relationships with clients. Partners, who by the very nature of their responsibilities must meet with business executives on their own ground, tend to develop social contacts with clients. Presumably, partners in a public accounting firm have demonstrated the maturity, judgment, and breadth of view that will enable them to maintain a proper balance between friendship with clients and professional independence.

When the element of sex enters the picture, the formulation of precise rules of conduct becomes more difficult, if not impossible. Assume, for example, that a female executive and part owner of a client company and a male partner of the company's public accounting firm are known to be constant companions during off business hours. The public would probably find it difficult to

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believe that the CPA would be truly independent in auditing the business in which his friend played such an important role.

In-Class Team Case

1-41 SOLUTION: Types of Services Provided by CPAs (Estimated time: 15 minutes)

The following are typical replies relating to this very general question. The purpose of this team exercise is to consider employment options within the profession of accounting. Students will typically have many concerns relating to this topic and an early discussion may provide them with helpful background information.

(a) Tax services performed by public accounting firms fall into the categories of compliance work and tax planning. Compliance work involves preparing the federal, state, and local tax returns of clients. Tax planning involves consulting with clients on how to structure their business affairs to minimize the amount and postpone the payment of taxes. Tax work while working for a corporation is similar in that it deals with compliance and with planning. It differs, however, in that the work will be performed for the one company, and not the broad range of clients typical of a public accounting firm. This obviously has advantages in terms of developing expertise related to the company.

Taxation work for the General Accounting Office will relate primarily to studies of general compliance with tax laws. Internal Revenue Service deals completely with compliance with various federal tax laws.

(b) Public accounting firms have historically emphasized the auditing of financial statements, although expansion of the attest function to a number of other areas is currently occurring. Auditing work with corporations generally involves working in the internal auditing department of that corporation. In addition to auditing financial information, internal auditing staff members devote a significant amount of time to operational and compliance audits.

The auditing work with the General Accounting Office includes both compliance and operational audits. Internal Revenue Service auditing work is, as indicated, related to compliance with various federal tax laws.

(c) Public accounting firms become involved with systems design both through audits and through consulting services. In audits, CPAs must analyze their clients' internal control, as well as make recommendations for improvements. However, public accounting firms that audit public companies may not perform systems consulting for those clients. Similarly, internal auditors for corporations, as well as information technology specialists become involved in systems design.

The General Accounting Office and the Internal Revenue do not typically become involved in systems design beyond that needed to perform compliance audits, and in the case of the GAO, operational audits.

Research and Discussion Case

1-42 SOLUTION: Smith & Co. (Estimated time: 30 minutes)

(a) The following arguments might be advanced in favor of allowing public accounting firms to sell ownership interests to non-accountants through incorporation:

- Access to capital is improved and will lead to an efficient allocation of resources within the economy.

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- Because public accounting firms compete against companies that are allowed to obtain capital in such a manner, they should not be constrained to capital available from accountants and loans.

- The fact that in this case the CPAs own 51 percent of the stock limits any possible negative effects on service quality which might result from non-accountant involvement.

- From the perspective of the public accounting firm, the possibility of liability that is limited to the amount of corporate assets is appealing.

- CPAs compete internationally, and it does not serve this country's interests to limit their ability to obtain capital.

(b) The following arguments might be advanced in favor of the restriction of firm ownership:

- The professional yet personal nature of the service involved may be affected negatively as shareholders exert pressure on CPAs which negatively affects the quality of their work.

- Any limits on personal liability may negatively affect those harmed by negligent performance by the firm.

- Limiting public accounting firms to sole practitioner, partnership and professional corporation status has served the public well over the years and there appear to be only limited advantages to allowing public ownership.

(c) There is no obvious answer to this case. Note that the situation today is very much unsettled as few states currently allow traditional incorporation under any circumstances. However, the traditional ability of CPAs to obtain adequate capital leads us to question whether the possible advantages of traditional incorporation are adequate to overcome the fairly significant arguments against it.

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