

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The Role of Essay Questions in the Uniform CPA Examination

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September 15, 1998

To Boards of Accountancy and Other Interested Parties:

The attached Discussion Memorandum is intended to provide Boards of Accountancy and other interested parties with information about the use of essay questions and problems on the Uniform CPA Examination.

In 1997, the AICPA Board of Examiners requested that the NASBA Examinations Committee study the role of essay questions and problems on the Uniform CPA Examination. While the NASBA Examinations Committee has recommended the discontinuation of essay questions and problems in their current form, the AICPA Board of Examiners believes that this recommendation is premature and that there are a number of issues, not yet fully addressed, that must be considered before a final decision is made.

Concurrently with the request to the NASBA Examinations Committee, the Board of Examiners charged its Examination Content Oversight Task Force (COTF) to "ensure that the content specifications of the Uniform CPA Examination reflect the knowledge and skills needed by entry-level CPAs to practice public accountancy competently." To meet its charge, the COTF is planning a national practice analysis and is studying how best to assess the skills needed by an entry-level CPA for the protection of the public interest. In addition, the Joint AICPA/NASBA Computerization Implementation Committee (CIC) is considering the types of questions that are feasible to use on a computer-based test.

The issues being addressed by the COTF and the CIC, as well as a variety of additional issues, have significant implications for the use of essay questions and problems on the Uniform CPA Examination.

Therefore, the Board of Examiners has three purposes in issuing this Discussion Memorandum:

- To provide interested parties with a balanced look at the major questions and findings regarding essay questions and problems,
- To elicit comments from interested parties on both their points of view and suggestions regarding essay questions and problems.
- To request that boards of accountancy defer action on the inclusion or exclusion of essay questions and problems until all the relevant facts have been aired and discussed.

The Board of Examiners welcomes your written comments concerning this important issue and asks that you send your comments to James D. Blum (via fax at 201-938-3443 or via email at jblum@aicpa.org). If sufficient interest is generated, the AICPA will work with the NASBA Examinations Committee to sponsor a one-day conference to continue the discussion.

The Board of Examiners is dedicated to continued collaboration with the Boards of Accountancy, the NASBA Examinations Committee, candidates, and the profession to ensure the best possible Uniform CPA Examination for protecting the public interest.

Sincerely,

A handwritten signature in black ink that reads "Stephen M. Walker". The signature is written in a cursive, flowing style.

Stephen M. Walker, CPA
Chair, Board of Examiners

Executive Summary

The AICPA Board of Examiners (BOE) is aware that the role of essay questions and problems (essays/problems) on the Uniform CPA Examination (the Examination) has been the subject of much recent debate. Some boards of accountancy (boards) are concerned about the value of having essays/problems on the Examination. This Discussion Memorandum sets forth the issues to assist boards and other interested parties in evaluating the role of essays/problems on the Examination.

The NASBA Examinations Committee has issued a report—*The Role of Essays in the Uniform CPA Examination*, prepared with the assistance of Michael Kane (*Examinations Committee Report*)—that suggests essays/problems add little in assessing the knowledge and skills needed by a CPA entering the profession. Based on this report, the Examinations Committee has recommended to boards that the use of essay questions as currently developed and graded be discontinued. The BOE believes that this recommendation is premature and that there are a number of issues, not yet fully addressed, that must be considered before a final decision is made.

This is not the first time the issue of discontinuing essays/problems from the Examination has been considered. In 1987, the BOE issued an exposure draft proposing that the Examination be changed to 100% objective questions. Boards, educators, and CPAs involved in all areas of the accounting profession, as well as candidates, soundly rejected the BOE's proposal for an all-objective Examination. Further, many respondents, including a number of boards, insisted that writing skills be assessed on the Examination. After considering all the comments, the BOE withdrew its proposal to eliminate essays/problems. Further, it agreed to assess writing skills for all candidates, not just those near the passing score.

The NASBA CPA Examination Review Board in its management letter continued to recommend that essay questions and problems be eliminated from the Examination. In 1997, the BOE requested that the NASBA Examinations Committee study the role of essays/problems on the Examination. At the same time, the BOE charged its Examination Content Oversight Task Force (COTF) to “ensure that the content specifications of the Uniform CPA Examination reflect the knowledge and skills needed by entry-level CPAs to practice public accountancy competently.”

The central issue of how best to test the knowledge and skills required of an entry-level CPA to protect the public interest is complex. The *Examinations Committee Report* is a first step that addresses the statistical issue of reliability. The psychometric work in the report suggests that essays/problems do not add much to the reliability of the Examination beyond that contributed by objective questions. However, the report does not provide sufficient evidence that essays/problems are not needed to protect the public interest. In addition, the report contains certain assertions regarding such matters as subjectivity of grading, protection of the public, the time required to report grades, and costs that, in the BOE's opinion, are not supported by the facts.

The BOE believes that the *Examinations Committee Report* raises a number of issues that warrant further attention. However, because the report does not adequately address the content validity issues that would result if essays/problems were eliminated from the Examination, much work remains to be completed before a well-reasoned, defensible conclusion about the value of essays/problems can be reached.

Many of these issues are being addressed by the COTF and by the Joint AICPA/NASBA Computerization Implementation Committee (CIC). These two groups are looking for ways to best test the knowledge and skills needed by entry-level CPAs.

Since the Examination currently meets or exceeds the psychometric standards for licensure examinations, the BOE believes that eliminating essays/problems without further study is premature and may impair the validity of Examination grades in making licensing decisions. In addition, the BOE believes that issues such as public confidence in the Examination are critically important and need to be fully explored before deciding to eliminate essays/problems from the Examination. Cost/benefit analyses, consideration of the timing of changes in light of the plans to administer the Examination by computer, and the effects on the various stakeholders (the public, boards of accountancy, candidates, and the profession), must be part of any decision to make major changes in the Examination format.

Other work that needs to be completed before a conclusion about the value of essays/problems can be reached includes:

- A more complete evaluation that addresses validity issues and a practice analysis that determines the knowledge and skills to be assessed.
- An evaluation of alternative testing methods available when the Examination administration becomes computerized, among them simulations to test critical skills.
- Detailed and on-going dialogues with stakeholders, including boards of accountancy, educators, and the profession, about the role of the Examination.

Accordingly, the BOE requests that boards defer action on discontinuing the use of essays/problems until the COTF and CIC have completed their studies of the Examination's content, structure, and delivery, and until additional dialogue and evaluation of this critical issue have taken place.

The Board of Examiners welcomes suggestions and comments on this important issue. You may send them to:

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1. Introduction

- 1.1. The AICPA Board of Examiners (BOE) is aware that the role of essay questions and problems (essays/problems) on the Uniform CPA Examination (the Examination) has been the subject of much recent debate. Some boards of accountancy (boards) are concerned about the value of having essays/problems on the Examination. This *Discussion Memorandum* sets forth the issues to assist boards and other interested parties in evaluating the role of essays/problems on the Examination.
- 1.2. In 1997, the BOE requested that the NASBA Examinations Committee study the role of essays/problems on the Examination. The NASBA Examinations Committee has issued a report—*The Role of Essays in the Uniform CPA Examination*, prepared with the assistance of Michael Kane (*Examinations Committee Report*)¹—that suggests essays/problems add little in assessing the knowledge and skills needed by a CPA entering the profession. Based on this report, the Examinations Committee has recommended to boards that the use of essay questions as currently developed and graded be discontinued.
- 1.3. The BOE is concerned that the *Examinations Committee Report* is being treated as a definitive evaluation demonstrating that essays/problems have little value on the Examination. In reality, the *Examinations Committee Report* is a first look at the role of essays on one Examination from a psychometric perspective. The *Examinations Committee Report* leaves unanswered many questions that need to be addressed before a well-founded decision can be made. One goal of this *Discussion Memorandum* is to raise those questions and stimulate relevant discussion on the issues.
- 1.4. A valid Examination plays a critical role in helping boards assess whether CPA candidates have the requisite knowledge and skills to be licensed as CPAs. The key charge in developing a valid Examination that protects the public interest is to identify what knowledge and skills should be tested, and how to best test those knowledge and skills.
- 1.5. Both components of this charge—identifying *what* and *how* to test—are among the issues being addressed by the AICPA Examination Content Oversight Task Force (COTF) and Joint AICPA/NASBA Computerization Implementation Committee (CIC). These two groups are looking for the best ways to test the knowledge and skills needed by entry-level CPAs.
- 1.6. The psychometric work discussed in the *Examinations Committee Report* suggests that essays/problems do not add much to the reliability of the Examination beyond that contributed by objective questions. However, the *Examinations Committee Report* does not provide sufficient evidence that essays/problems are not needed to protect the public interest. The last two practice analyses provided substantial evidence that higher cognitive skills are important to protect the public interest and should be tested on the Examination.² These higher cognitive skills (e.g., identify issues, draft/review financial statements including disclosures, document procedures, findings, and conclusions, formulate efficient and effective (audit) procedures to accomplish objectives, and organize and document information) are tested primarily through essays/problems. In fact, the *Examinations Committee Report* states: “To the extent that the essays provide valid assessment of skills that are important in CPA

¹ *The Role of Essays in the Uniform CPA Examination* (NASBA Examinations Committee, January 2, 1998).

² *Report of the Practice Analysis Task Force* (AICPA, September 1983) and *Practice Analysis of Certified Practice Accountants in Public Accounting* (AICPA, May 1991).

practice, but are not adequately measured by objective items, the essays would make an important contribution to the protection of the public.”³

- 1.7. Since the Examination currently meets or exceeds the psychometric standards for licensure examinations⁴, the BOE believes that eliminating essays/problems without further study is premature and may impair the validity of Examination grades in making licensing decisions. The BOE believes that boards should consider the work of the COTF and the CIC, including the results of the forthcoming practice analysis and computer feasibility studies, before making a decision on changing question formats (i.e. multiple-choice, other objective answer formats (OOAFs), essays/problems, and simulations).
- 1.8. The BOE requests that boards consider all of the facts set forth in this *Discussion Memorandum* and the future findings of the COTF and CIC so that they can make informed decisions on the use of essays/problems on the Examination.

³ *The Role of Essays in the Uniform CPA Examination* (NASBA Examinations Committee, January 2, 1998), p. 1.

⁴ *Board of Examiners Uniform CPA Examination Annual Report 1997* (AICPA, June 1998) pp. 17–31.

2. Background

- 2.1. The objective of the Examination is to provide reasonable assurance to the boards that candidates passing the Examination possess the technical knowledge and skills necessary for initial licensure to protect the public interest. The Examination assures each board that CPAs entering the profession have passed an examination that is uniform in its content coverage and level of difficulty and that uses consistent grading practices.
- 2.2. The scope of the Examination includes entry-level knowledge and skills that bear a reasonable relationship to the audit and attestation, taxation, and other functions normally performed by entry-level CPAs that affect the public interest and for which CPAs have particular professional expertise. The content of the Examination is based primarily on the results of two national studies of CPAs in public practice. Consequently, the Examination tests a wide range of knowledge and skills that CPAs need to plan and implement public accounting engagements. See Appendix A for details on the Examination's structure, content, and criteria for the evaluation of writing skills.
- 2.3. Multiple-choice and OOF questions primarily assess understanding and application of authoritative sources, as well as certain analytical skills. Essays/problems are used on three of the four Examination sections⁵ primarily to assess higher-level thinking, analytical, organizational, and written communication skills. Essays/problems require candidates to use such high-level skills as the ability to analyze data, identify issues, identify and evaluate alternatives, and formulate conclusions. The essays/problems currently constitute 20 percent of the total grade on each of the three Examination sections.
- 2.4. In addition, a group of skills labeled "writing skills" is graded explicitly. Writing skills encompass organizational and communication skills and are assessed to ensure entry-level CPAs have the basic skills needed to produce an accounting or auditing work product that is organized, concise, and clear, which is essential to the protection of the public interest. Appendix A provides information on how writing skills are assessed. Appendix B provides examples of essays/problems that have appeared on recent Examinations.⁶

History of Essay Questions/Problems on the Examination

- 2.5. From 1917 through 1947, essays/problems constituted 100% of the questions on the four Examination sections. Until the 1970s, the majority of the questions continued to be essays/problems. Beginning in the 1980s all four sections consisted of 60% multiple-choice questions and 40% essays/problems.
- 2.6. In 1987, the BOE issued an exposure draft⁷ proposing that the Examination be changed to 100% objective questions. Boards, educators, CPAs involved in all areas of the profession, and candidates soundly rejected this proposal. Further, many respondents, including a number of boards, insisted that writing skills be assessed for all candidates. (At that time, writing skills were assessed on the Examination only for candidates whose grades were within five

⁵ Business Law & Professional Responsibilities, Auditing, and Financial Accounting & Reporting.

⁶ The questions in Appendix B have appeared in *Selected Questions and Unofficial Answers Indexed to Content Specification Outlines* (AICPA, 1998). Released questions are not used in future Examinations.

⁷ Exposure Draft, *Proposed Changes in the Uniform CPA Examination* (AICPA Board of Examiners, March 16, 1987).

points of passing. For those candidates, essay/problem solutions were reviewed for clarity, conciseness, and organization.) After considering all the comments, the BOE withdrew its proposal to eliminate essays/problems. Further, it agreed to assess writing skills for all candidates. Currently, five percent of the total grade on three of the four sections is allocated to assessing writing skills. See Appendix A for details on how writing skills are evaluated.

- 2.7. A 1991 practice analysis of CPAs in public practice identified the most important skills needed by entry-level CPAs.⁸ Such skills included the ability to evaluate, analyze and assess data and to formulate conclusions (analytical thinking skills); the ability to document procedures, findings and conclusions; and the ability to communicate conclusions (organizational and writing skills). The 1983 practice analysis looked at 269 knowledge, skills, and abilities according to four criteria: frequency of use, importance to work activity, where learned, and need to know. Writing skills was the highest-ranked skill of the 269 items being assessed.⁹
- 2.8. Since analytical thinking and organizational and written communication skills are critical competencies for entry-level CPAs, the Examination should test these skills if possible. If it does not, those who rely on the Examination to help protect the public interest will have no assurance that those who pass the Examination have these critical skills. The focus should be on determining the best way to test these skills.
- 2.9. With a paper-and-pencil examination, the essay/problem format appears to be the best way to test the critical skills identified in the practice analyses. However, the BOE believes that any decision concerning the continued use of essays/problems on the Examination must fully consider the advantages and disadvantages of these types of questions.

⁸ *Practice Analysis of Certified Practice Accountants in Public Accounting* (AICPA, May 1991).

⁹ *Report in the Practice Analysis Task Force* (AICPA, September 1983).

3. Advantages and Disadvantages of Essays/ Problems

Advantages

3.1. There are several advantages in retaining essays/problems:

- 3.1.1. *Enhanced skills assessment.* Essays/problems offer the ability to assess skills that are important to entry-level practice that cannot be assessed effectively by objective questions. For example, the 1991 report *Practice Analysis of Certified Public Accountants in Public Accounting* identified a number of these skills, including “identify issues,” “formulate efficient and effective procedures to accomplish objectives,” “formulate conclusions,” “prepare communications,” “document issues, facts, information obtained, and conclusions,” and “organize and document information.” Litigation involving CPAs, including government enforcement actions, frequently involves situations where the CPA did not adequately demonstrate these types of skills. As a result the public was harmed. Some of these skills, including organization, conciseness, and clarity, are considered “writing skills” and are currently assessed using the essay portions of the Examination. Problems are used to assess, among other skills, candidates’ abilities to produce, evaluate, and correct financial statements.
- 3.1.2. *Consistency with current licensing examination practices.* Many examination programs in the licensing field have added, or are considering adding, performance assessments to supplement the objective portions of their examinations. For the most part, these assessments simulate practice and include either the development of a work product (a legal brief) or a simulation of a work process (diagnosis of a patient’s problem). Typical essays/problems on the Uniform CPA Examination require preparation of a report or require candidates to identify the issues and arrive at an acceptable solution (see Appendix B). Such examination components are sometimes called “authentic,” because they test skills more like those used in practice than do pure objective tests. Eliminating essays/problems without substituting other types of performance assessments, such as computer simulations, would be construed by many as conflicting with current trends in licensing examination practices.
- 3.1.3. *Enhanced validity.* In test and measurement terminology, validity refers to the degree to which an examination is measuring what it intends to measure. Content validity is the type of validity most relevant to licensure examinations. Content validity refers to how well the examination covers the identified domain of knowledge and skills needed by a licensee to practice in a manner that safeguards the public interest. For the Uniform CPA Examination, this domain is represented by its content specifications (see Appendix A). Each Examination administered embodies a sample of the content specifications. Content validity is enhanced by including essays/problems, because they test knowledge and skills not tested by objective questions. In addition, if removing essays/problems from the Examination were to lead potential CPA candidates to conclude that critical skills, such as organizational and written communication skills and some of the other critical skills enumerated in paragraphs 1.6 and 3.1.1, are not required to pass the Examination, the validity of the Examination could be further impaired. This would happen if candidates no longer are required to develop these skills when preparing for the Examination. In addition, people who currently would not consider taking the Examination because they lack the skills needed to pass a test that includes essays/problems could decide to take, and then pass, an all-objective Examination. This would not help boards protect the public interest.

- 3.1.4. Grading writing and organizational skills reinforces the message to candidates that technical knowledge is insufficient without the ability to communicate that knowledge clearly in writing. The BOE believes it is probable that entry-level CPAs' writing and organizational and other initial critical skills would suffer if essays/problems were removed from the Examination. A decline in these skills would impair the ability of boards to rely on Examination grades in making decisions about whom to license as CPAs to protect the public interest.
- 3.1.5. *Confidence in the Examination.* If essays/problems were eliminated many members of the public and the profession (possibly including some who are on state boards) likely would no longer accept the Examination as a valid licensing examination because they would not believe it tested the skills and depth of knowledge needed to perform the activities for which CPAs are licensed.

Disadvantages

- 3.2. The BOE identified several disadvantages of essays/problems in its 1987 exposure draft, "*Proposed Changes in the Uniform CPA Examination.*" These included:
 - 3.2.1. *Limitations on validity.* For a given amount of testing time, multiple-choice questions can provide broader coverage of an examination's content specifications than can essays/problems and OOAFs, potentially improving the Examination's content validity.
 - 3.2.2. *Limitations on reliability.* In addition to assessing knowledge and skills in the defined content domain, an examination must assess such knowledge and skills consistently. Consistency of measurement is referred to as *reliability*. The easiest way to improve reliability is to increase the number of measurement points (scorable units) on an examination. Essays/problems may limit the reliability of the grades on the Examination because, compared to objective questions, they test the subject matter in greater depth but with fewer measurement points per unit of testing time than an examination containing only objective questions.
 - 3.2.3. *Limitations on grader reliability.* Reliability of grades may also be limited whenever examinations are graded by individuals. This is particularly true when many papers must be graded in a limited time. Consistency of grades on papers graded by the same person may vary over time, and consistency of grading among graders may vary as well. The AICPA Advisory Grading Service minimizes inconsistencies through extensive training and monitoring of graders. Examination papers near the pass/fail or conditioning scores are reviewed up to two additional times to ensure the papers are graded fairly, consistently, and accurately. The success of the training, monitoring, and review processes is evidenced by the fact that of the millions of papers scored as part of the AICPA's Advisory Grading Service, very few grades have been changed from failing to passing. Of those few grades that have changed, almost all have been due to scanner errors on objective questions, not errors in grading essays/problems.
 - 3.2.4. *Extended time to report grades.* An all-objective Examination would require less time to grade than one that includes essays/problems. Currently, all advisory grades are delivered to boards within nine weeks of the Examination administration date. Boards release grades to candidates approximately 13 weeks after the Examination administration date. If essays/problems were discontinued, the AICPA Examinations team anticipates that advisory grades could be delivered to the boards within six weeks. Accordingly, candidates could receive their grades ten weeks after the Examination is administered, instead of the current 13 weeks.

- 3.3. Despite the disadvantages outlined in the 1987 exposure draft, the overwhelming consensus of boards, educators, CPAs involved in all areas of the profession, and candidates was that the Examination should continue to include essays/problems. However, now that the Examination is nondisclosed, the use of essays/problems has two additional disadvantages.
- 3.3.1. *Complications in pretesting.* With the adoption of a nondisclosed Examination, most multiple-choice questions graded on the Examination have been pretested to ensure they function within established statistical parameters. However, essays/problems and OOAFs are considered “memorable,” i.e., relatively easy to remember, because they are fewer in number, worth more points, and longer than multiple-choice questions, and because they test the content in greater depth. Not only can memorable questions be disclosed more readily to others who later may take the Examination, they are more valuable to candidates because of their higher point values. In addition, the historically high Examination failure rates mean that many candidates retake a section of the Examination at least once, and often multiple times. Consequently, memorability is a potentially important factor in Examination grades for repeat candidates. Accordingly, essays/problems and OOAFs are not reused, and therefore cannot be pretested effectively.
- 3.3.2. *Complications in equating.* By using pretested nondisclosed questions, each Examination can be statistically equated. Equating adjusts grades for differences in Examination difficulty while controlling for changes in candidates’ performance. Equating requires using a core group of pretested questions with known statistical properties. Therefore, only multiple-choice questions can be included in the equating procedure because other types of questions are not pretested. Because the essays/problems and OOAFs cannot be included in the core group of questions, the equating procedure may be less optimal than it would be with an all multiple-choice Examination.

4. Current Initiatives Related to Examination Content and Format

- 4.1. Two of the challenges in developing the Examination are to identify the knowledge and skills that should be tested, and to determine the best methods of testing those knowledge and skills. Currently, the AICPA's Examination Content Oversight Task Force is addressing the knowledge and skills to test and the most effective methods of testing them, and the AICPA/NASBA Computerization Implementation Committee is addressing the feasibility of those methods.

The Content Oversight Task Force (COTF)

- 4.2. The COTF was formed in 1996 and charged to “ensure that the content specifications of the Examination reflect the knowledge and skills needed by entry-level CPAs to practice public accountancy competently.” In January 1997, the COTF issued *Invitation to Comment—Updating the Uniform CPA Examination Content Specifications*. In October 1997, the COTF issued *Status Report—Updating the Uniform CPA Examination Content Specifications*, which was based on the comments received, and formed five working groups to address the most pressing issues identified. The COTF also recommended, and the BOE adopted, minor technical changes to update the content specification outlines. These changes became effective with the May 1998 Examination.
- 4.3. One working group is ascertaining the skills needed by entry-level CPAs to protect the public interest, whether those skills can be assessed on written and computerized examinations, and how best to assess those skills. That working group also is determining the technical knowledge and skills to be assessed using the simulations proposed for the computerized examination.
- 4.4. The COTF also is planning a full-scale practice analysis to ensure that the knowledge and skills tested on the Examination continue to reflect those needed in practice by entry-level CPAs to protect the public interest.

Joint AICPA/NASBA Computerization Implementation Committee (CIC)

- 4.5. The AICPA and NASBA formed the CIC in 1997 to develop and implement a computer-based Examination. In September 1995, the BOE issued *Invitation to Comment—Conversion of the Uniform CPA Examination to a Computer Based Examination*. The responses received, summarized in a *Status Report* issued in June 1997, indicated that computerizing the Examination has the support of a wide majority of boards and other interested parties.¹⁰
- 4.6. Consistent with the preference of the majority of respondents to the invitation to comment, the tentative structure for the computer-based Examination is a two-section test. One section of the Examination would consist entirely of multiple-choice questions and focus primarily on assessing the fundamental knowledge needed by entry-level CPAs. This section would be a computer mastery test. The computer offers the opportunity to expand the traditional multiple-choice test by, for example, offering on-line research tools.

¹⁰ *Status Report—Conversion of the Uniform CPA Examination to a Computer Based Examination* (AICPA Board of Examiners, June 1997).

- 4.7. The other section would consist of various types of performance assessments and would focus primarily on testing the skills needed by entry-level CPAs. The CIC is looking at the feasibility and value of including computerized simulations on the Examination to better assess some of the higher cognitive skills that CPAs need and that cannot be tested by multiple-choice questions. If simulations prove feasible, they can be used to supplement or replace essays/problems in a computer-based testing environment.
- 4.8. The CIC has targeted the year 2003 for implementing a computer-based Examination. The joint committee is dedicated to identifying the issues involved in computerizing the Examination, to keeping interested parties fully informed, and to receiving on-going feedback from all stakeholders.

5. Discussion of the NASBA Examinations Committee Report

- 5.1. A report about the inclusion of essays/problems on the Examination was written by NASBA's Examinations Committee with the assistance of its consulting psychometrician, Dr. Michael Kane.¹¹ Much of the recent concern about continuing to include essays/problems on the Examination has come from this report. The report summarized many of the disadvantages of retaining essays/problems on the Examination highlighted in the BOE's 1987 Exposure Draft. After evaluating the pros and cons of essays/problems, the report concludes, "If we restrict attention to how well the [Examination] is measuring the specific knowledge and skills required for practice as a CPA, the extensive resources currently being devoted to the development and scoring of essays could probably be more profitably spent in developing a variety of OOAF item sets to expand the range of what is covered by the objective tests."¹²
- 5.2. There are a number of reasons to question the use of the Examinations Committee's study as the primary determinant to eliminate essays/problems from the Examination. Among them:
- 5.2.1. The assumption in the report that high-level skills, such as writing and organization (and some of the other critical skills enumerated in paragraph 1.6 and 3.1.1) are not required for practice as a CPA is contradicted by evidence from the 1983 and 1991 practice analysis studies that clearly showed that writing, organization, and the other skills are very important to the protection of the public and needed at entry level.
- 5.2.2. Based solely on the May 1996 Uniform CPA Examination, the *Examinations Committee Report* concludes that the extent to which essay scores cannot be predicted from the objective scores is attributable to random error.¹³ The psychometric evidence for this conclusion is incomplete, and the method used, based on the standard error of measurement, is an approach that has not been used in common psychometric research or appeared in the literature.
- 5.2.3. The *Examinations Committee Report* suggests that the cost of using essays/problems is quite high ["the inclusion of essays ... adds substantially to the cost of the process."¹⁴]. In fact, the costs of developing and grading essays/problems are estimated to be about \$16.00—less than 18% of the \$90 examination fee charged to boards for a candidate taking all four Examination sections, and less than 9% of the average fee charged to candidates. The \$16 estimate does not include any offsetting costs of developing (currently essays/problems constitute 15% of the total points on the four sections combined) and grading additional objective questions.
- 5.2.4. The *Examinations Committee Report* points out that "essays do not fit in well with standard approaches to computer adapted testing and therefore may introduce additional complexity if the CPA examinations are to be computerized."¹⁵ This statement is correct. However, the CIC's current proposal is to implement a two-section computerized test, with one section being a multiple-choice computer mastery test, not a computer adaptive test, and the other section comprising a series of performance assessments.
- 5.2.5. The *Examinations Committee Report* contains an analysis indicating that inclusion of essays/problems apparently does not have a large effect on who passes or who fails the

¹¹ *The Role of Essays in the Uniform CPA Examination* (NASBA Examinations Committee, January 2, 1998).

¹² *Ibid.*, p. 16.

¹³ *Ibid.*, p. 16.

¹⁴ *Ibid.*, p. 16.

¹⁵ *Ibid.*, p. 5.

Examination.¹⁶ The report correctly concludes that this is not surprising “because the essays contribute relatively few points to the total score”¹⁷ on three Examination sections. It goes on to point out that the effect is even smaller for the assessment of writing skills, because it accounts for only 5% of the score on those three Examination sections. However, the same could be said of any 5% or less of a section’s content specifications (e.g. fraud or financial instruments—see Appendix A). Removal of the essays/problems could impair the Examination’s content validity because some of the important entry-level skills that are explicitly assessed using essays/problems—including organization and other writing skills—cannot be assessed meaningfully with objective questions.

- 5.3. The BOE believes that the *Examinations Committee Report* raises a number of issues that warrant further attention. However, the BOE also believes that a critical decision like eliminating essays/problems should not be made based on the psychometric evaluation of a single Examination, using unproven research methodology.

¹⁶ Ibid., p. 11–13.

¹⁷ Ibid., p. 13.

6. Conclusions—Call for Further Study

- 6.1. In the BOE's judgment, eliminating essays/problems from the Examination at this time is premature. Because the effect of eliminating essays/problems on the validity of the Examination as a whole is unknown, the BOE believes that action on essays/problems should be deferred until the COTF and the CIC have progressed further in their missions, and the result of the forthcoming practice analysis and feasibility studies can be considered.
- 6.2. In addition, the BOE believes that issues such as public confidence in the Examination are critically important and need to be fully explored before deciding to eliminate essays/problems from the Examination. Cost/benefit analyses, consideration of the timing of changes in light of the plans to administer the Examination by computer, and the effects on the various stakeholders (the public, boards of accountancy, candidates, and the profession), must be part of any decision to make major changes in the Examination's format.
- 6.3. The central issue of how best to test the knowledge and skills required of an entry-level CPA to protect the public interest is complex. The *Examinations Committee Report* is a first step that addresses the statistical issue of reliability. However, because the report does not adequately address content validity, other work needs to be completed before a conclusion about the value of essays/problems can be reached. This work includes:
- A more complete evaluation that addresses validity issues, and a practice analysis that determines the knowledge and skills to be assessed.
 - An evaluation of alternative testing methods available when the Examination administration becomes computerized, among them simulations to test critical skills.
 - Detailed and on-going dialogues with stakeholders, including boards of accountancy, educators, and the profession, about the role of the Examination.
- 6.4. Accordingly, the BOE requests that boards defer action on discontinuing the use of essays/problems until the COTF and CIC have completed their studies of the Examination's content, structure, and delivery, and until additional dialogue and evaluation of this critical issue have taken place.

The Board of Examiners welcomes your suggestions and comments. You may send them to:

Board of Examiners
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Appendix A

Excerpts from Information for *Uniform CPA Examination Candidates* (Fourteenth Edition)

- Examination Structure and Times
- Examination Focus and Content
- * Content by Section
- * Evaluation of Writing Skills

Examination Structure and Times

The examination consists of four separate sections. These sections are administered over a two-day period with the following time allocations:

<i>Section</i>	<i>Hours</i>	<i>Day</i>	<i>Time</i>
Business Law & Professional Responsibilities	3.0	Wednesday	9:00 A.M.–12:00 NOON
Auditing	4.5	Wednesday	1:30 P.M.–6:00 P.M.
Accounting & Reporting— Taxation, Managerial, and Governmental and Not-for- Profit Organizations	3.5	Thursday	8:30 A.M.–12:00 NOON
Financial Accounting & Reporting	<u>4.5</u>	Thursday	1:30 P.M.–6:00 P.M.
Total	<u><u>15.5</u></u>		

The examination questions and answers are given and graded only in English.

Candidates' knowledge and skills are assessed by requiring responses to questions in three different formats:

- Four-option multiple-choice format
- Other objective answer format
- Essay question or problem format

These formats are assigned the following percentages for each examination section:

<i>Section</i>	<i>Format</i>		
	<i>Four-Option Multiple-Choice</i>	<i>Other Objective Answer Formats</i>	<i>Essay Questions or Problems</i>
Business Law & Professional Responsibilities	50 – 60%	20 – 30%	20 – 30%
Auditing	50 – 60%	20 – 30%	20 – 30%
Accounting & Reporting— Taxation, Managerial, and Governmental and Not-for- Profit Organizations	50 – 60%	40 – 50%	None
Financial Accounting & Reporting	50 – 60%	20 – 30%	20 – 30%

Examination Focus and Content

Focus of the Examination

The focus of the examination is on the broad range of knowledge and skills CPAs need to plan and implement a public accounting engagement. Thus, the examination tests a broad range of skills, at various cognitive levels, that are necessary to practice as a CPA. The cornerstone to answering examination questions is knowledge and the comprehension of that knowledge. In addition to knowledge, many answers require application and analytical skills related to business information. Still other answers, especially essays and problem solutions, require evaluation, judgment, presentation, and decision-making ability related to accounting and auditing information in business situations.

All sections of the examination test a candidate's analytical skills. Examples of these skills are:

- Analyzing information and identifying data relevant to the situation.
- Assessing materiality and identifying risk.
- Identifying and explaining auditing procedures, accounting and reporting situations, and potential legal issues.
- Understanding and evaluating information technology.
- Evaluating situations, formulating conclusions, and making recommendations.
- Preparing auditing and accounting findings, conclusions, and recommendations in written report format.

Content by Section

The Content Specification Outlines have been revised to reflect changes enacted by the Board of Examiners in late 1997. These changes, effective for the May 1998 Uniform CPA Examination, have been prompted by new pronouncements and changes in the profession, such as the effect of computers on the practice of public accountancy.

Auditing

The auditing section covers knowledge of generally accepted auditing standards and procedures and the skills needed to apply them in auditing and other attestation engagements. This section tests that knowledge and those skills, as appropriate, in the context of the four broad engagement tasks that follow.

Auditing content specification outline

- I. Plan the engagement, evaluate the prospective client and engagement, decide whether to accept or continue the client and the engagement, and enter into an agreement with the client (40%)
 - A. Determine nature and scope of engagement
 1. Generally accepted auditing standards
 2. Standards for accounting and review services
 3. Standards for attestation engagements

4. Compliance auditing applicable to governmental entities and other recipients of governmental financial assistance
 5. Other assurance services
 6. Appropriateness of engagement to meet client's needs
- B. Assess engagement risk and the CPA firm's ability to perform the engagement
1. Engagement responsibilities
 2. Staffing and supervision requirements
 3. Quality control considerations
 4. Management integrity
 5. Researching information sources for planning and performing the engagement
- C. Communicate with the predecessor accountant/auditor
- D. Decide whether to accept or continue the client and engagement
- E. Enter into an agreement with the client as to the terms of the engagement
- F. Obtain an understanding of the client's operations, business, and industry
- G. Perform analytical procedures
- H. Consider preliminary engagement materiality
- I. Assess inherent risk and risk of misstatements
1. Errors
 2. Fraud
 3. Illegal acts by clients
- J. Consider internal control
1. Obtain and document an understanding of internal control—automated and manual
 2. Assess control risk
 3. Consider limitations of internal control
 4. Consider the effects of information technology on internal control
 5. Consider the effects of service organizations on internal control
- K. Consider other planning matters
1. Using the work of other independent auditors
 2. Using the work of a specialist
 3. Internal audit function
 4. Related parties and related party transactions
 5. Electronic evidence
- L. Identify financial statement assertions and formulate audit objectives
1. Accounting estimates
 2. Routine financial statement balances, classes of transactions, and disclosures
 3. Unusual financial statement balances, classes of transactions, and disclosures
- M. Determine and prepare the work program defining the nature, timing, and extent of the auditor's procedures
- II. Obtain and document information to form a basis for conclusions (35%)
- A. Perform planned procedures including planned applications of audit sampling
1. Tests of controls
 2. Analytical procedures
 3. Confirmation of balances and/or transactions with third parties

4. Physical examination of inventories and other assets
 5. Other tests of details
 6. Computer assisted audit techniques
 7. Substantive tests prior to the balance sheet date
 8. Tests of unusual year-end transactions
- B. Evaluate contingencies
 - C. Obtain and evaluate lawyers' letters
 - D. Review subsequent events
 - E. Obtain representations from management
 - F. Identify reportable conditions and other control deficiencies
 - G. Identify matters for communication with audit committees
- III. Review the engagement to provide reasonable assurance that objectives are achieved and evaluate information obtained to reach and to document engagement conclusions (5%)
- A. Perform analytical procedures
 - B. Evaluate the sufficiency and competence of audit evidence and document engagement conclusions
 1. Consider substantial doubt about an entity's ability to continue as a going concern
 2. Evaluate whether financial statements are free of material misstatements
 3. Consider other information in documents containing audited financial statements
 - C. Review the work performed to provide reasonable assurance that objectives are achieved
- IV. Prepare communications to satisfy engagement objectives (20%)
- A. Prepare reports
 1. Reports on audited financial statements
 2. Reports on reviewed and compiled financial statements
 3. Reports required by *Government Auditing Standards*
 4. Reports on compliance with laws and regulations
 5. Reports on internal control
 6. Reports on prospective financial information
 7. Reports on agreed-upon procedures
 8. Reports on other assurance services
 9. Reports on the processing of transactions by service organizations
 10. Reports on supplementary financial information
 11. Other special reports
 12. Reissuance of reports
 - B. Prepare letters and other required communications
 1. Errors and fraud
 2. Illegal acts
 3. Special reports
 4. Communication with audit committees
 5. Other reporting considerations covered by statements on auditing standards and statements on standards for attestation engagements

C. Other matters

1. Subsequent discovery of facts existing at the date of the auditor's report
2. Consideration of omitted procedures after the report date

Suggested publications to study—auditing

- AICPA Statements on Auditing Standards
- AICPA Statements on Standards for Accounting and Review Services
- AICPA Statements on Quality Control Standards
- AICPA Statements on Standards for Attestation Engagements
- U.S. General Accounting Office *Government Auditing Standards*
- AICPA Audit and Accounting Guides:
 - Audit Sampling
 - Consideration of Internal Control in a Financial Statement Audit
- Textbooks and articles on auditing and other assurance services
- AICPA Auditing Procedure Studies
- AICPA Audit and Accounting Manual
- AICPA Top 10 Technologies and Their Impact on CPAs
- AICPA Risk Alerts
- SECPS Practice Alerts
- Single Audit Act, as amended
- Information on auditing and other assurance services on the AICPA Website

Sample questions for auditing are included in Appendix A and on the AICPA's Website at <http://www.aicpa.org/exams>.

Financial accounting & reporting

The financial accounting & reporting section tests candidates' knowledge of generally accepted accounting principles for business enterprises and the skills needed to apply them in a public accounting engagement. Content covered in this section includes financial accounting concepts and standards as well as their application in a public accounting engagement. Candidates will

- Obtain and document entity information for use in financial statement presentations
- Evaluate, analyze, and process entity information for reporting in financial statements
- Communicate entity information and conclusions
- Analyze information and identify data relevant to financial accounting and reporting
- Identify financial accounting and reporting methods and select those that are suitable
- Perform calculations and formulate conclusions
- Present results in writing in a financial statement format or other appropriate format

Financial accounting & reporting content specification outline

- I. Concepts and standards for financial statements (20%)
 - A. Financial accounting concepts
 - B. Financial accounting standards for presentation and disclosure in general purpose financial statements
 1. Consolidated and combined financial statements
 2. Balance sheet
 3. Statement(s) of income, comprehensive income, and changes in equity accounts
 4. Statement of cash flows
 5. Accounting policies and other notes to financial statements
 - C. Other presentations of financial data
 1. Financial statements prepared in conformity with comprehensive bases of accounting other than generally accepted accounting principles
 2. Personal financial statements
 3. Prospective financial information
 - D. Financial statement analysis
- II. Recognition, measurement, valuation, and presentation of typical items in financial statements in conformity with generally accepted accounting principles (40%)
 - A. Cash, cash equivalents, and marketable securities
 - B. Receivables
 - C. Inventories
 - D. Property, plant, and equipment
 - E. Investments
 - F. Intangibles and other assets
 - G. Payables and accruals
 - H. Deferred revenues
 - I. Notes and bonds payable
 - J. Other liabilities
 - K. Equity accounts
 - L. Revenue, cost, and expense accounts

- III. Recognition, measurement, valuation, and presentation of specific types of transactions and events in financial statements in conformity with generally accepted accounting principles (40%)
- A. Accounting changes and corrections of errors
 - B. Business combinations
 - C. Cash flow components—financing, investing, and operating
 - D. Contingent liabilities and commitments
 - E. Discontinued operations
 - F. Earnings per share
 - G. Employee benefits
 - H. Extraordinary items
 - I. Financial instruments
 - J. Foreign currency transactions and translation
 - K. Income taxes
 - L. Interest costs
 - M. Interim financial reporting
 - N. Leases
 - O. Nonmonetary transactions
 - P. Quasi-reorganizations, reorganizations, and changes in entity
 - Q. Related parties
 - R. Research and development costs
 - S. Segment reporting

Suggested publications to study—financial accounting & reporting

- Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board Opinions, and AICPA Accounting Research Bulletins
- FASB Technical Bulletins
- AICPA Statement on Auditing Standards No. 69, “The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles* in the Independent Auditor’s Report,” and Statement on Auditing Standards No. 62, “Special Reports”
- AICPA Personal Financial Statements Guide
- FASB Statements of Financial Accounting Concepts
- AICPA Statements of Position
- Books and articles on accounting

Sample questions for financial accounting & reporting are included in Appendix A and on the AICPA’s Website at <http://www.aicpa.org/exams>.

Accounting & reporting—taxation, managerial, and governmental and not-for-profit organizations

The accounting & reporting—taxation, managerial, and governmental and not-for-profit organizations section tests candidates' knowledge of principles and procedures for federal taxation, managerial accounting, and accounting for governmental and not-for-profit organizations, and the skills needed to apply them in a public accounting engagement.

Federal taxation

This portion covers knowledge applicable to federal taxation and its application in practice. Candidates will

- Analyze information and identify data relevant for tax purposes
- Identify issues, elections, and alternative tax treatments
- Perform required calculations
- Formulate conclusions

Federal taxation content specification outline

- I. Federal taxation—individuals (20%)
 - A. Inclusions in gross income
 - B. Exclusions and adjustments to arrive at adjusted gross income
 - C. Deductions from adjusted gross income
 - D. Filing status and exemptions
 - E. Tax accounting methods
 - F. Tax computations, credits, and penalties
 - G. Alternative minimum tax
 - H. Tax procedures
- II. Federal taxation—corporations (20%)
 - A. Determination of taxable income or loss
 - B. Tax accounting methods
 - C. S corporations
 - D. Personal holding companies
 - E. Consolidated returns
 - F. Tax computations, credits, and penalties
 - G. Alternative minimum tax
 - H. Other
 1. Distributions
 2. Incorporation, reorganization, liquidation, and dissolution
 3. Tax procedures
- III. Federal taxation—partnerships (10%)
 - A. Basis of partner's interest and bases of assets contributed to the partnership
 - B. Determination of partner's share of income, credits, and deductions
 - C. Partnership and partner elections
 - D. Partner dealing with own partnership
 - E. Treatment of partnership liabilities

- F. Distribution of partnership assets
 - G. Termination of partnership
- IV. Federal taxation—estates and trusts, exempt organizations, and preparers’ responsibilities (10%)
- A. Estates and trusts
 - 1. Income taxation
 - 2. Determination of beneficiary’s share of taxable income
 - 3. Estate and gift taxation
 - B. Exempt organizations
 - 1. Types of organizations
 - 2. Requirements for exemption
 - 3. Unrelated business income tax
 - C. Preparers’ responsibilities

Suggested publications to study—federal taxation

- Internal Revenue Code and Income Tax Regulations
- Internal Revenue Service Circular 230
- AICPA Statements on Responsibilities in Tax Practice
- Income tax textbooks

Governmental and not-for-profit organizations

This portion covers knowledge applicable to accounting for governmental and not-for-profit organizations and its application in practice. Candidates will

- Analyze and identify information relevant to governmental and not-for-profit accounting and reporting
- Identify alternative accounting and reporting policies and select those appropriate in specific situations
- Distinguish the relative weight of authority of differing sources of generally accepted accounting principles
- Perform procedures, formulate conclusions, and present results

Governmental and not-for-profit organizations content specification outline

- V. Accounting for governmental and not-for-profit organizations (30%)
 - A. Governmental entities
 - 1. Measurement focus and basis of accounting
 - 2. Objectives of financial reporting
 - 3. Uses of fund accounting
 - 4. Budgetary process
 - 5. Financial reporting entity
 - 6. Elements of financial statements
 - 7. Conceptual reporting issues
 - 8. Accounting and financial reporting for state and local governments
 - a. Governmental-type funds and account groups
 - b. Proprietary-type funds

- c. Fiduciary-type funds
- 9. Accounting and financial reporting for governmental not-for-profit organizations (including hospitals, colleges and universities, voluntary health and welfare organizations and other governmental not-for-profit organizations)
- B. Nongovernmental not-for-profit organizations
 - 1. Objectives of financial reporting
 - 2. Elements of financial statements
 - 3. Formats of financial statements
 - 4. Accounting and financial reporting for nongovernmental not-for-profit organizations
 - a. Revenues and contributions
 - b. Restrictions on resources
 - c. Expenses, including depreciation

Suggested publications to study—governmental and not-for-profit organizations

- Governmental Accounting Standards Board (GASB) Statements, Interpretations, and Technical Bulletins
- Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board Opinions, AICPA Accounting Research Bulletins, and FASB Technical Bulletins
- FASB Statement of Financial Accounting Concepts No. 4, “Objectives of Financial Reporting by Nonbusiness Organizations,” and FASB Statement of Financial Concepts No. 6, “Elements of Financial Statements”
- AICPA Statement on Auditing Standards No. 69, “The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles* in the Independent Auditor’s Report”
- AICPA Audit and Accounting Guides and Statements of Position relating to governmental and not-for-profit organizations
- Governmental and not-for-profit accounting textbooks and other accounting textbooks containing pertinent chapters

Managerial accounting

This portion covers knowledge applicable to managerial accounting and its application in accounting practice. Candidates will

- Analyze and interpret information as a basis for decision making
- Determine product and service costs
- Prepare and interpret information for planning and control

Managerial accounting content specification outline

- VI. Managerial accounting (10%)
 - A. Cost estimation, cost determination, and cost drivers
 - B. Job costing, process costing, and activity based costing
 - C. Standard costing and flexible budgeting
 - D. Inventory planning, inventory control, and just-in-time purchasing
 - E. Budgeting and responsibility accounting
 - F. Variable and absorption costing

- G. Cost-volume-profit analysis
- H. Cost allocation and transfer pricing
- I. Joint and by-product costing
- J. Capital budgeting
- K. Special analyses for decision making
- L. Product and service pricing

Suggested publications to study—managerial accounting

- Managerial accounting textbooks and other accounting textbooks containing pertinent chapters
- Accounting periodicals

Sample questions for accounting & reporting are included in Appendix A and on the AICPA's Website at <http://www.aicpa.org/exams>.

Business law & professional responsibilities

The business law & professional responsibilities section tests candidates' knowledge of a CPA's professional responsibilities and of the legal implications of business transactions, particularly as they relate to accounting and auditing. Content covered in this section includes a CPA's professional responsibilities, business organizations, contracts, debtor-creditor relationships, government regulation of business, the Uniform Commercial Code, and property. Candidates will be required to

- Recognize relevant legal issues
- Recognize the legal implications of certain business situations
- Apply the underlying principles of law to accounting and auditing situations

This section deals with federal and widely adopted uniform laws. If there is no federal or uniform law on a topic, the questions are intended to test knowledge of the law of the majority of jurisdictions. Professional ethics questions are based on the AICPA *Code of Professional Conduct* because it is national in its application, whereas codes of other organizations and jurisdictions may be limited in their application.

Business law & professional responsibilities content specification outline

- I. Professional and legal responsibilities (15%)
 - A. Code of professional conduct
 - B. Proficiency, independence, and due care
 - C. Responsibilities in other professional services
 - D. Disciplinary systems imposed by the profession and state regulatory bodies
 - E. Common law liability to clients and third parties
 - F. Federal statutory liability
 - G. Privileged communications and confidentiality
 - H. Responsibilities of CPAs in business and industry, and in the public sector
- II. Business organizations (20%)
 - A. Agency
 1. Formation and termination
 2. Duties of agents and principals
 3. Liabilities and authority of agents and principals
 - B. Partnership, joint ventures, and other unincorporated associations
 1. Formation, operation, and termination
 2. Liabilities and authority of partners and owners
 - C. Corporations
 1. Formation and operation
 2. Stockholders, directors, and officers
 3. Financial structure, capital, and distributions
 4. Reorganization and dissolution
 - D. Estates and trusts
 1. Formation, operation, and termination
 2. Allocation between principal and income
 3. Fiduciary responsibilities
 4. Distributions

- III. Contracts (10%)
 - A. Formation
 - B. Performance
 - C. Third party assignments
 - D. Discharge, breach, and remedies
- IV. Debtor-creditor relationships (10%)
 - A. Rights, duties, and liabilities of debtors and creditors
 - B. Rights, duties, and liabilities of guarantors
 - C. Bankruptcy
- V. Government regulation of business (15%)
 - A. Federal securities acts
 - B. Employment regulation
 - C. Environmental regulation
- VI. Uniform commercial code (20%)
 - A. Negotiable instruments
 - B. Sales
 - C. Secured transactions
 - D. Documents of title
- VII. Property (10%)
 - A. Real property including insurance
 - B. Personal property including bailments and computer technology rights

Suggested publications to study—business law & professional responsibilities

- *AICPA Code of Professional Conduct*
- AICPA Statements on Auditing Standards dealing explicitly with proficiency, independence, and due care
- AICPA Statement on Standards for Consulting Services
- AICPA Statements on Responsibilities in Personal Financial Planning Practice
- Books covering business law, auditing, and accounting

Sample questions for business law & professional responsibilities are included in Appendix A and on the AICPA's Website at <http://www.aicpa.org/exams>.

Evaluation of Writing Skills

Writing Skills

Selected essay answers in the business law & professional responsibilities, auditing, and financial accounting & reporting sections are used to assess candidates' writing skills. Five percent of the total points available on each of these sections will be allocated to writing skills. Effective writing can be characterized by the following six elements:

1. *Coherent organization.* The writer arranges ideas in a smooth, logical flow, enabling the reader to easily follow the train of thought. The writer develops each main idea in a separate paragraph and places the idea in the first sentence of the paragraph. Sentences that follow describe, define, clarify, illustrate, or explain the principal idea. Connectives and transition words link sentences and paragraphs.
2. *Conciseness.* The writer conveys points in as few words as possible without scrimping on important detail or substance. Short sentences and simple wording contribute to concise writing.
3. *Clarity.* A clearly written response expresses the writer's meaning or reasoning to the intended reader. Well-constructed sentences and carefully chosen words, including proper technical terms, contribute to clarity.
4. *Use of standard English.* Effective responses use standard English, which is defined in *The Business Writer's Handbook* as follows:

There are two broad varieties of written English: standard and nonstandard. These varieties are determined through **usage** by those who write in the English language. Standard English ... is used to carry on the daily business of the nation. It is the language of business, industry, government, education, and the professions. Standard English is characterized by exacting standards of **punctuation** and capitalization, by accurate **spelling**, by exact **diction**, by an expressive vocabulary, and by knowledgeable usage choices.¹

5. *Responsiveness to the requirements of the question.* The writer should address the requirements of the question and demonstrate awareness of the purpose of the writing task. Answers should not be broad expositions on the general subject but should focus on the specific elements presented in the question. However, answers should not be so narrowly focused that they omit key elements of the requirements.
6. *Appropriateness for the reader.* Writing that is appropriate for the reader takes into account the reader's background, knowledge of the subject, interests, and concerns. Some essay questions may require candidates to prepare a written document for a specific reader, such as a memorandum to a CPA's client. In such cases, technical terms may have to be defined for the specific reader. When the requirements do not identify a specific reader, the candidate should assume the intended reader is a knowledgeable CPA.

¹ Charles T. Brusaw, Gerald J. Alred, and Walter E. Oliu, *The Business Writer's Handbook*, 4th Ed. (New York: St. Martin's Press, 1993), page 227.

Appendix B

Examples of Current Essay Question/Problems

Audit Question

On September 3, 1997, Larkin, CPA, was engaged to audit the financial statements of Modern Minerals Co. for the year ended October 31, 1997. Modern purchases precious metals at wholesale prices and resells them to craft clubs at retail. Modern is a new client whose common stock was first offered to the public in 1994. Modern received an unqualified opinion on its financial statements in each of the prior three years but changed auditors after each engagement. In accepting the engagement, Larkin completed all the appropriate client-acceptance procedures. Larkin instructed Johnson, an assistant on the engagement, to draft a planning checklist that would assist Larkin in preparing the audit staff for the field work that is scheduled to begin on October 17, 1997. On October 5, 1997, Johnson prepared the planning checklist below.

Planning checklist for the Modern Minerals (MM) engagement:

I. Understanding the assignment

In planning the audit, have engagement personnel considered:

- MM's accounting policies and procedures?
- Financial statement items likely to require adjustment?
- The nature of the reports expected to be rendered?
- The effects of accounting and auditing pronouncements, particularly new ones?
- The method of sampling likely to be approved by MM?
- The extent of involvement of other independent auditors or internal auditors?

In planning the audit, have engagement personnel discussed:

- The general scope and timing of the audit work with MM's management, board of directors, or audit committee?
- The expected level of detection risk with MM's management, board of directors, or audit committee?

II. Assigning personnel to the engagement

Has a time budget for the engagement been prepared to determine the staffing requirements and to schedule the field work and has it been approved by:

- The engagement partner?
- MM's controller and audit committee?

Has the engagement staffing schedule been approved by the engagement partner?

Have the following factors been considered:

- Engagement size and complexity?
- Personnel available?
- Timing of the work to be performed?
- Continuity and periodic rotation of personnel?
- Opportunities for on-the-job training?

III. Knowledge of the entity's business

Has an overall understanding of MM's operations been obtained by reviewing:

- Minutes of stockholders' and board of directors' meetings?
- Filings with regulatory agencies?
- Recent management letters?
- The Codification of Statements on Auditing Standards?

Have engagement personnel obtained knowledge of MM's organization and operating characteristics?

Have the methods that MM uses to process accounting information been considered?

Have the extent, complexity, and organizational structure of MM's computer activities and their effects on the audit been considered and evaluated?

IV. Assessing auditability

Has the adequacy of the accounting records been assessed for proper:

- Descriptions of transactions to permit the appropriate financial statement classification?
- Information about transactions to permit the recording of appropriate monetary amounts?
- Recording of transactions in the appropriate accounting period?

Have the following factors regarding the integrity of management been considered in planning the audit:

- Responses to previous inquiries of local attorneys, bankers, and other business leaders regarding MM's standing in the community?
- MM's credit rating?

Have inquiries of a sample of MM's customers regarding MM's credit-granting policies been made?

V. Engagement letter

Have the following items been addressed in the engagement letter:

- Name of the entity and its year end?
- Statements to be audited?
- Scope of services?
- Type of report to be rendered?
- Larkin's responsibilities for detecting fraud?
- Larkin's responsibility for assuring that MM meets its SEC filing deadlines?
- MM's obligations to prepare statements and schedules?
- Requirement that Larkin read all printed material in which the auditor's report appears?
- Larkin's responsibility for the preparation or review of tax returns?
- Provision for MM's acceptance signature and date?

Have the following items been considered for inclusion in the engagement letter:

- Name of MM's personnel to be contacted during the engagement?
- Description of particular audit procedure(s) requested by MM?
- Cooperation with the internal auditors?
- Date when Larkin's detailed audit program will be available for MM's review?
- List of certain services specifically excluded?
- MM's acknowledgment of its responsibility for the financial statements?
- A statement that MM will be informed of any reportable conditions that come to Larkin's attention?

VI. Assessing risk

Have inherent risk and control risk been assessed to determine how much detection risk can be accepted?

Has consideration been given to permitting MM's internal auditors to make judgments about the assessment of inherent risk and evaluations of significant accounting estimates?

If control risk is assessed at below the maximum level for some or all financial statement assertions, has that conclusion been documented?

If control risk is assessed at the maximum level for some or all assertions:

- Have specific internal control activities that are likely to prevent or detect material misstatements in those assertions been identified?
- Have tests of controls to evaluate the design and operation of such activities been performed?
- If a further reduction in the assessed level of control risk is desired for some assertions, have additional tests of relevant controls been performed?
- Has the basis for the conclusion that control risk is assessed at the maximum level for some or all assertions been documented?

VII. Illegal acts

Have the following matters been considered in assessing the risk that MM has not complied with laws and regulations that have a direct and material effect on the financial statements:

- MM's policy relative to the prevention of illegal acts?
- MM's understanding of the requirements of laws and regulations pertinent to its business?
- Internal control components designed to give MM reasonable assurance that MM complies with those laws and regulations?

VIII. Analytical procedures

In planning the audit, have analytical procedures been used that focus on:

- Enhancing an understanding of MM's business and the transactions and events of the year under audit?
- Identifying areas that may represent specific risks relevant to the audit?
- Achieving particular audit objectives?
- Evaluating the overall financial statement presentation?

IX. Audit strategies and the audit program

Has the audit program been developed for the engagement and approved by the engagement partner?

Required:

A. Identify the inappropriate comments and misconceptions that exist in Johnson's planning checklist and describe why each is inappropriate or a misconception.

B. Describe the additional considerations and comments that should be addressed in Johnson's planning checklist.

Audit Answer

A. In section I, Understanding the assignment, Johnson's planning checklist includes a question implying that the method of sampling used by Larkin, the auditor, should be approved by MM, the client. Evaluating the competence of evidential matter is solely a matter of the auditor's professional judgment. Therefore, the choice of statistical or nonstatistical sampling in achieving audit objectives will be controlled by Larkin without MM's approval.

Also, in section I, the checklist implies that Larkin's engagement personnel will discuss the expected level of detection risk with MM's management, board of directors, or audit committee. It is usually inappropriate for an auditor to discuss this with a client, especially with management, because the level of detection risk is a matter of the auditor's professional judgment.

In section II, Assigning personnel to the engagement, the checklist includes a question concerning MM's approval of Larkin's time budget. The time budget may be discussed with the audit committee and the controller, but its approval is solely within the CPA firm and it should not be subject to approval by the client because the CPA firm controls the nature, timing, and extent of the work to be done.

In section III, Knowledge of the entity's business, Johnson has included the Codification of Statements on Auditing Standards (SASs) as a source of understanding MM's operations. Although the SASs are interpretations of the generally accepted auditing standards, they do not provide an auditor with specific knowledge about an entity or a specific industry.

In section IV, Assessing auditability, the inquiries of MM's customers about MM's credit-granting policies are inappropriate. This is not the type of information ordinarily obtained from a client's customers.

In section V, Engagement letter, the reference to Larkin's responsibility for assuring that MM meets its SEC filing deadlines is inappropriate because it is the client's responsibility to meet its SEC filing deadlines.

Also, in section V, Johnson's checklist implies that Larkin's detailed audit program will be made available for MM's review. The auditor's audit program and the corresponding working papers document the work done during the engagement and are not ordinarily shared with the client. The client neither reviews the audit program before nor after the procedures are performed.

In section VI, Assessing risk, Johnson mistakenly allows the internal auditors to make judgments about the assessment of inherent risk and evaluations of significant accounting estimates. These matters are solely within the exercise of the independent auditor's professional judgment and may not be delegated to the internal auditors.

Also, in section VI, the concept of control risk assessed at the maximum level is confused with control risk assessed at **below** the maximum. If control risk is assessed at the maximum level for some or all of the assertions, the auditor need only document that conclusion. If control risk is assessed at **below** the maximum, internal control activities must be identified and tested to evaluate the design and operation of the activities, and the basis for that conclusion must be documented.

Finally, in section VIII, some of Johnson's questions have missed the purpose of analytical procedures in the planning phase of an audit. Achieving particular audit objectives and evaluating the overall financial statement presentation are not the purposes of analytical procedures performed in the planning stage of the audit.

B. In preparing the planning checklist, Johnson has omitted any questions about the need to consider engaging specialists in determining the value of MM's inventory of precious metals. Closely associated with this need is the consideration of whether special expertise may be required by Larkin's staff members who are assigned to the engagement. This consideration also has not been addressed in the checklist.

Johnson has not included any questions regarding the method of audit sampling to be used on the engagement.

Johnson has not prepared any questions addressing the coordination and cooperation of MM's employees who most likely will be assisting Larkin's staff members in data preparation and in obtaining documents and the time required for MM's employees to perform these functions.

Johnson's checklist omitted any reference to reviewing the predecessor auditor's working papers. Johnson also omitted any reference to Larkin's use of the predecessor auditor's responses to Larkin's inquiries.

Audit Answer (continued)

Johnson should have included questions about the review of the prior year's financial statements and the current year's interim financial statements to assure that Larkin has sufficient knowledge of MM's business.

To obtain an understanding of MM's business, Johnson should have included questions about the engagement personnel's familiarity with economic conditions, government regulations, and specialized accounting practices.

Johnson has omitted any reference to obtaining an understanding of internal control sufficient to plan the audit, including the control environment, risk assessment, control activities, information and communication, such as MM's computer system, and monitoring.

Johnson's section of the checklist that covers engagement letter issues should have addressed the need for determining fees and any arrangements agreed-upon for the frequency of billing.

Although audit risk has been considered in preparing the checklist, materiality has not. Johnson has not prepared questions concerning whether a preliminary judgment about the dollar amount of misstatement that would be material to MM's financial statements has been made.

Johnson has substantially omitted all questions concerning assessing the risk that errors and irregularities/fraud may be present in MM's financial statements. Management characteristics such as unduly aggressive financial reporting and engagement characteristics such as the existence of related party transactions should be addressed. Questions also should be prepared concerning management's predisposition to distort financial statements and change auditors annually, lack of control over computer processing, and indications of constant crisis conditions in operating and accounting areas.

Finally, Johnson has omitted any questions that could assist Larkin in assessing the competence and objectivity of MM's internal auditors. Larkin most likely would be interested in such factors as the professional experience and certification of the internal auditors and their organizational status.

FARE Question

The following information relates to the obligations of Villa Watch Co. as of December 31, 1997:

- Accounts payable for goods and services purchased on open account amounted to \$35,000 at December 31, 1997.
 - On December 15, 1997, Villa declared a cash dividend of \$.05 per common share, payable on January 12, 1998, to shareholders of record as of December 31, 1997. Villa had 1,000,000 shares of common stock issued and outstanding throughout 1997.
 - On December 30, 1997, Villa entered into a six-year capital lease on a warehouse and made the first annual lease payment of \$100,000. Villa's incremental borrowing rate was 12%, and the interest rate implicit in the lease, which was known to Villa, was 10%. The rounded present value factors for an annuity due for six years are 4.6 at 12% and 4.8 at 10%.
 - On July 1, 1997, Villa issued \$500,000, 8% bonds for \$440,000 to yield 10%. The bonds mature on June 30, 2003, and pay interest annually every June 30. At December 31, 1997, the bonds were trading on the open market at 86 to yield 12%. Villa uses the effective interest method.
 - Villa's 1997 pretax financial income was \$850,000 and its taxable income was \$600,000. The difference is due to \$100,000 of permanent differences and \$150,000 of temporary differences related to noncurrent assets. At December 31, 1997, Villa had cumulative taxable differences of \$300,000 related to noncurrent assets. Villa's effective tax rate is 30%. Villa made no estimated tax payments during the year.
- Contingency information:
 - Villa has been named a liable party for toxic waste cleanup on its land, and must pay an as-yet undetermined amount for environmental remediation activities.
 - An adjoining landowner, Clear Toothpaste Co., sold its property because of possible toxic contamination of the water supply and resulting potential adverse public reaction toward its product. Clear sued Villa for damages. There is a reasonable possibility that Clear will prevail and be awarded between \$250,000 and \$600,000.
 - As a result of comprehensive risk assessment, Villa has discontinued rockslide insurance for its warehouse, which is located at the base of a mountain. The warehouse has never sustained rockslide damage, and the probability of sustaining future damage is only slight.

Required:

Begin the answer to each requirement (i.e., A, B, and C) on the top of a new page.

A. Prepare the liabilities section of Villa's December 31, 1997, balance sheet.

B. Discuss the information Villa is required to disclose, either in the body of the financial statements or the notes thereto, related to bonds payable and capital leases included in the liabilities presented above.

C. Explain how Villa should account for each contingency in its 1997 financial statements. Discuss the theoretical justification for each accounting treatment.

FARE Answer

**A. *Villa Co.*
BALANCE SHEET—LIABILITIES SECTION
December 31, 1997**

Accounts payable	\$ 35,000	
Accrued interest payable	20,000	[2]
Income taxes payable	180,000	[3]
Dividends payable	50,000	
Current portion, long-term debt	<u>62,000</u>	[1]
Total current liabilities	<u>347,000</u>	
Capital lease payable, less \$62,000 current portion	318,000	[1]
Bonds payable	442,000	[2]
Deferred tax liability	<u>90,000</u>	[3]
Total liabilities	<u><u>\$1,197,000</u></u>	

[1] $\$100,000 \times 4.8 = \$480,000$
 $\$480,000 - \$100,000 = \$380,000$
 $\$380,000 \times 10\% = \$38,000$
 $\$100,000 - \$38,000 = \$62,000$
 $\$380,000 - \$62,000 = \$318,000$

[2] $500K \times 8\% \times \frac{1}{2} = 20K$
 $440K \times 10\% \times \frac{1}{2} = 22K$
 $440K + (22K - 20K) = 442,000$

[3] $600K \times 30\% = 180K$
 $300K \times 30\% = 90K$

B. Villa should disclose the following information about the capital leases, either in the body of the financial statements or in the notes thereto:

- The gross amount of assets recorded under the capital leases, presented by major classes. This information may be combined with owned assets.
- Future minimum lease payments as of the balance sheet date, in the aggregate and for each of the five succeeding years.
- A general description of the leasing arrangement, including the existence and terms of renewal, escalation clauses, and restrictions imposed by the lease agreements.

Villa should disclose the following information about the bonds payable, either in the body of the financial statements or in the notes thereto:

- The face amount.

- The nature and terms of the bonds and a discussion of their credit and market risk, cash requirements, and related accounting policies.
- The fair value of the bonds and the method used to estimate their fair value. The price at which the bonds are trading is the most reasonable estimate of their fair value at December 31, 1997.

C. Villa should account for each contingency in a slightly different way because the likelihood of Villa's incurring a loss differs in each situation.

For the toxic waste cleanup, a loss has been incurred. In the notes to its financial statements, Villa should disclose the nature of the loss on cleanup and indicate that an estimate of the loss, or range of the loss, cannot be made. No accrual should be made because the loss cannot be reasonably estimated and accrual of an uncertain amount would impair the integrity of the financial statements.

With regard to Clear's claim it is only reasonably possible, and not probable, that Villa will have to pay. Accordingly, Villa should not accrue the loss. Villa should disclose the existence and nature of Clear's claim in the notes to its financial statements. Disclosure should include an estimate of the potential range of loss.

Regarding the lack of rockslide insurance, no asset has been impaired and no liability has been incurred. Accordingly, Villa should not accrue a loss. Since the likelihood of a rockslide is remote, disclosure of the uninsured risk, while permitted, is not required.

LPR Question

On June 1, Classic Corp., a manufacturer of desk chairs, orally agreed to sell 100 leather desk chairs to Rand Stores, a chain of retail furniture stores, for \$50,000. The parties agreed that delivery would be completed by September 1, and the shipping terms were “F.O.B. seller’s loading dock.” On June 5, Classic sent Rand a signed memorandum of agreement containing the terms orally agreed to. Rand received the memorandum on June 7 and made no response.

On July 31, Classic identified the chairs to be shipped to Rand and placed them on its loading dock to be picked up by the common carrier the next day. That night, a fire on the loading dock destroyed 50 of the chairs. On August 1, the remaining 50 chairs were delivered to the common carrier together with 50 vinyl chairs. The truck carrying the chairs was involved in an accident, resulting in extensive damage to 10 of the leather chairs and 25 of the vinyl chairs.

On August 10, the chairs were delivered to Rand. On August 12, Rand notified Classic that Rand was accepting 40 of the leather chairs and 10 of the vinyl chairs, but the rest of the shipment was being rejected. Rand also informed Classic that, due to Classic’s failure to perform under the terms of the contract, Rand would seek all remedies available under the Sales Article of the UCC.

Classic contended that it has no liability to Rand and that the shipment was strictly an accommodation to Rand because Rand failed to sign the memorandum of agreement, thus preventing a contract from being formed.

The above parties and transactions are governed by the provisions of the Sales Article of the UCC.

Required:

A. Determine whether Classic’s contention is correct and give the reasons for your conclusion.

B. Assuming that a valid contract exists between Classic and Rand, answer the following questions and give the reasons for your conclusions. Do not consider any possible liability owed by the common carrier.

1. Who bears the risk of loss for the 50 destroyed leather chairs?

2. Who bears the risk of loss for the 25 damaged vinyl chairs?

3. What is the earliest date that title to any of the chairs would pass to Rand?

C. With what UCC requirements must Rand comply to be entitled to recover damages from Classic?

D. Assuming that a valid contract exists between Classic and Rand, state the applicable remedies to which Rand would be entitled. Do not consider any possible liability owed by the common carrier.

LPR Answer

A. Classic's contention is incorrect. Under the provisions of the Sales Article of the UCC, a written memorandum stating an agreement between merchants does not have to be signed by both parties. The contract is enforceable against Classic because Classic signed the memorandum and against Rand because Rand did not object to the memorandum within 10 days of receiving it.

B.1. Classic bears the risk of loss for the 50 leather chairs destroyed in the fire. Even though the goods were identified to the contract and placed on the loading dock, the risk of loss remains with Classic. The shipping terms "F.O.B. seller's loading dock" provide that risk of loss remains with the seller until the goods are delivered to the common carrier. The 50 leather chairs destroyed in the fire had not yet been delivered to the carrier.

2. Classic bears the risk of loss for the damaged vinyl chairs. Even though these goods were delivered to the common carrier, the risk of loss did not pass to Rand because the vinyl chairs were nonconforming goods.

3. August 1 was the earliest date that title to any of the chairs passed to Rand. Title passed when goods identified to the contract were delivered to the carrier.

C. Under the Sales Article of the UCC, for Rand to be entitled to damages from Classic, Rand must comply with the following requirements:

- Rand has to notify Classic of the rejection of the goods within a reasonable time.
- Rand must act in good faith with respect to the rejected goods by following any reasonable instructions from Classic.
- Rand must give Classic the opportunity to cure until the contract time of performance expires.

D. Rand would be entitled to the following remedies:

- The right to cancel the contract.
- The right of cover.
- The right to recover monetary damages for non-delivery.