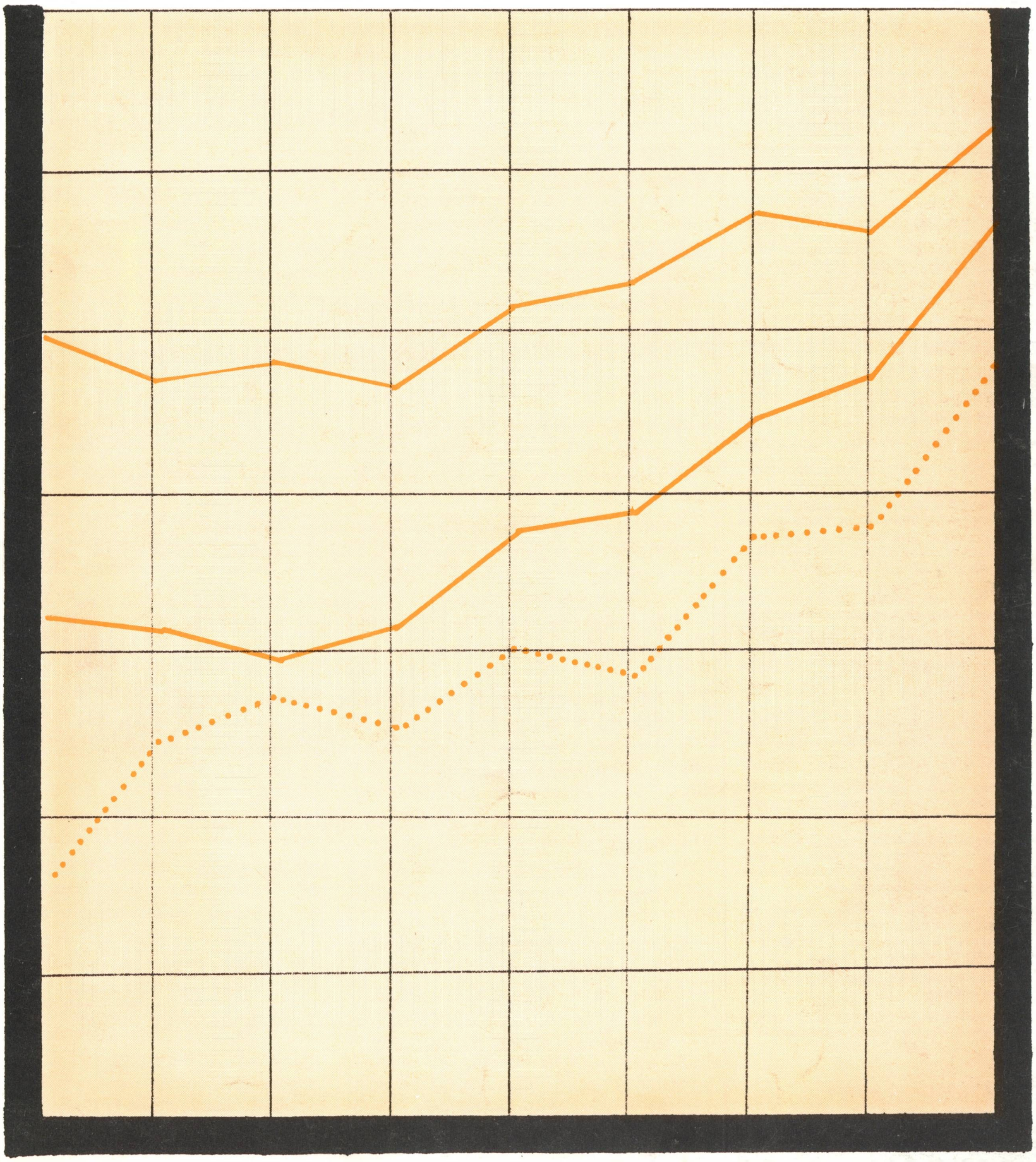
Woman CPA Volume 44, Number 4, October 1982

American Woman's Society of Certified Public Accountants

American Society of Women Accountants

The Woman CPA

OCTOBER, 1982 VOLUME 44 NUMBER 4



THE WOMAN CPA, (ISSN 0043-7271) published quarterly and copyrighted, 1982 by THE WOMAN CPA, 3998 Ridgedale Drive, Cincinnati, Ohio 45239. THE WOMAN CPA is a joint venture of the American Woman's Society of Certified Public Accountants, 500 North Michigan Avenue, Chicago, Illinois 60611 and the American Society of Women Accountants, 35 East Wacker Drive, Suite 1036, Chicago, Illinois 60601. Subscription rates per year — members and ASWA student members $3.00; all others $6.00; outside the United States $12.00 (orders for foreign mail will not be accepted other than by airmail printed matter rates); single copies $2.00 (domestic). Second class postage paid at Cincinnati, Ohio.

POSTMASTER: Send address changes to THE WOMAN CPA, 6600 Clough Pike, Cincinnati, OH 45244.

Change of address notices must be sent to Circulation Department giving both old and new addresses and zip code numbers. Please allow four weeks notice.

Manuscripts should be addressed to the Associate Editor, Manuscripts. Letters to the Editor, news items and other materials should be sent directly to the business office. Manuscript guidelines available upon request.

Views expressed therein are the authors and do not necessarily represent the policy of either Society. Permission to reprint articles appearing in any issue of THE WOMAN CPA is at the discretion of the Editor.

Requests for information regarding advertising should be sent to the Business Manager.

All remittances for subscriptions should be sent directly to the Business Manager. Checks should be made payable to THE WOMAN CPA.

CIRCULATION DEPARTMENT:

THE WOMAN CPA
P.O. Box 39295
Cincinnati, Ohio 45239

The Woman CPA

ISSN 0043-7271

OCTOBER, 1982 **VOLUME 44 NUMBER 4**

CONTENTS

Editor's Notes 1

ARTICLES

Is Public Accounting A Profession? 2
Edward A. Becker, CPA, CMA, MBA
The criteria that have been met, and the vulnerability of that meeting

The Tax Penalty On Marriage 5
John M. Strefeler, CPA, Ph.D.
Observations on the pervasive, persistent subsidy of "sin"

Practical Experience For Accounting Educators 11
Abdel A. Agami, CPA, Ph.D., Ula K. Motekat, CPA, DBA, and Stanley E. Warner, Jr., CPA, Ph.D.
How collegiate accounting teachers plan to meet the new accreditation standards requirement for continuing professional experience

A Reconsideration Of Capitalizing Interest Costs 16
Donna A. Dingus, CPA, and Roland L. Madison, CPA, Ph.D.
Appraisal of interest effects on the "predictive value" of financial statements

Audit Sampling — A Simplified Updated View 23
Russell F. Briner, CPA, Ph.D.
Significant elements of SAS No. 39, and their effect on the auditing process

Compilation And Review Reports 28
Thomas P. Edmonds, Ph.D., Mattie C. Porter, CPA, Ph.D., and Ira R. Weiss, CPA, Ph.D.
Survey of interpretations of the reports by certified public accountants, and by bankers.

Cover illustration by Jo Ellen McElwee

Editor's Notes

Was there ever such a season?

Leaves are drifting on the terrace, those same leaves that hung over the wall last week in a lacy red canopy, and draped a rich green umbrella during the heat of July. We knew it couldn't last; we expected the falling leaves. Next week, or sometime soon, a cold rain will pack the crisp yellow drift into a wet mass that will cling to the crevices where the brick terrace meets the wall. Mornings are chilly, nightfall is earlier, summer is indeed over, but then, we did expect it and that in itself is reassuring. But what if the cycle began to alter its pattern subtly, stealthily, leaving us unsure of tomorrow?

It does happen, every now and again, and so fragile is the human body and the ecosystem in which it moves that lives are lost when an aberrant cycle drops the mean temperature only a few degrees over a sustained period. There have been legendary years "without a summer" and years when blizzards came too early and raged until late in May, squeezing the life from hungry cattle and from indigent or improvident farmers, and savaging early Spring buds that could have ripened into fruit for the next season. This year autumn has come very early, or so it seems, and gloomy prophecies are beginning — usually citing volcanic ash in the stratosphere as cause but awaiting the sight of thickly furred woolybear caterpillars for authentication. Meanwhile, even the most urban of us are vaguely ill at ease with the premature and prevading chill.

We can be reasonably tranquil about unseasonable cold if we are served some scientific cause, and fallout from volcanic activity does sound plausible — although the dinosaurs would have argued the point about tranquility. But how to account for the on again, off again, rise in the stock market, along with the unremitting grip of unemployment? Everyone who has survived Economics 101 knows that business moves in cycles, with peaks and valleys following each other in staggering chart lines over the years. The cyclic pattern of business is just as certain as the law of supply and demand, Isn't it?

We are so attuned to rhythms, to night and day, to fall, winter, spring and summer, year in and year out; to childhood, maturity, and old age; to the very beat of our hearts. Women, in particular, feel the ebb and flow of vigor every month of their reproductive years. We know some city-dwellers who go on expeditions to sites where migrating birds congregate, just to watch the annual flight to a different domicile. Humankind is fascinated with the seashore, and the tidal pull is especially strong for children with their more recent link to origins.

It is when the cycles slow, or accelerate, or simply stop that we step back in fright. Premature death jolts us. Death in old age, by contrast, seems sweetly sad and almost like a benediction. After all, to every thing there is a season.

Perhaps our perspective on unreasonable, unseasonable chill, and on erratic stock markets would be improved if we could live longer. Meteorologists tell us that cycles of extreme cold repeat over long time spans, as evidenced by geological core findings and the telltale rings in the trunks of giant petrified trees. Of course geology does little to help with analysis of vacillations in the Dow Jones average but history of earlier economic crises does offer some insights, if not encouragement.

Within living memory we do see some recurring phenomena in the marketplace. For instance, as costs for central heating of homes increase, space heaters have again become the warm heart of the living area. Pot bellied stoves are trendy, along with a variety of less nostalgic heating devices. Thermal underwear used to be only for skiers and hunters, and long before that it was for all of us who remember wrapping the ends of the long legs securely around the ankles so that they didn't look so bulgy ugly under stockings. Now, everyone with right reason owns several sets of thermals in leg lengths to accomodate slacks, or shorter for wear with skirts. When it comes to coping with winter, some of us feel that we have come full circle.

Late in 1976 the accounting profession was subjected to Congressional criticism in respect to its apparent lack of independence in audit matters, and the Securities and Exchange Commission tightened disclosure requirements in corporate proxy statements concerning audit fees, and corporate approval of expanded consulting engagements by auditors. Government displayed its regulatory might in the posture of the SEC. Meanwhile, the profession's self-regulation response has been very effective, as is commonly acknowledged, and the SEC has recently rescinded some of its disclosure requirements and appears to be relaxing its role of stringent overseer. That was a short cycle, but a therapeutic one.

In September the Wall Street Journal observed that catalog sales of merchandise to working women have zoomed. Professional women, in particular, have become a computer-selected market segment to be tempted with delights in jewelry, fine china and crystal, works of art, bath and bed linens, gourmet cookware, Shannon airport duty-free luxuries, and, or course, elegant clothes. At the moment your editor's temptations number twenty-two catalogs, and it all seems quite ironic to an escapee from mail order clothing in childhood. The implied level of discretionary income is very flattering, however.

Cycles still revolve, and always will, in their diurnal, lunar, seasonal, galactic, and mundane socio-economic patterns, intertwined with our personal bio-rhythms. The times may seem out of joint, but how can we know for sure until we live for a millenium and beyond, or have the wisdom of Solomon?

Constance T. Barcelona

Is Public Accounting A Profession?

And Can It So Remain?

By Edward A. Becker

Rarely a month goes by that the current accounting publications do not have an article discussing some facet of professionalism in public accounting. Each of these articles discusses some issue the author feels is a part of professionalism; phrases like "attacks on the profession" are quite common. However none of these articles gets to the real heart of the problem; what is a professional? In 1962 Paul Dunham wrote a classic article in which he asked the question: Is management a profession? His answer was "no." The purpose of this article is to ask the same question about Certified Public Accountants.

Are Certified Public Accountants professionals? Are those practicing in the field working in a profession or in a technical trade? In order to answer those questions, this paper must first define "professional."

A common definition of professional is one which distinguishes between a person who gets paid for his activities and one who doesn't (amateur vs. professional). Within this framework, there are professional tennis players and amateur tennis players, professional carpenters and amateur carpenters, etc. This is not the concept of professional that this paper will explore. It is the concept of professional which differentiates between the physician and the assembly line worker (both of whom are paid for their services) that this paper will examine.

Prior to the industrial revolution, only three occupational groups, physicians, attorneys and theologians, were recognized as professionals. Within each group was a hierarchical ranking or order (Larson, 1977, p. 5). These groups had achieved the prestige and privileges accorded professionals because they had occupations which required extensive education and training and which provided for a human need; the physician satisfied the need for health, the attorney the need for justice and the theologian the spiritual needs. All three also had one other thing in common. The Common Law provided each with the right of privileged communication.

Modern times have complicated the definition of professional much as they have complicated life itself. Countless volumes have been written attempting to delineate the criteria for professionalism. Cullen (1978) summarizes some of these efforts on Table 1. The most useful typology of criteria is provided by Donham (1962). The following have been generally recognized as the four elements defining "profession."

> "1. A profession is characterized by a systematic body of specialized knowledge of substantial intellectual content.
>
> 2. A profession is characterized by a motive of service, by standards of conduct which govern all professional relationships and which take precedence over personal gain, and by acceptance of the social responsibility inherent in the profession.
>
> 3. A recognized educational process and standards of qualification for admission exist.
>
> 4. An organization is devoted to the advancement of the profession's social obligation and to the enforcement of standards of admission and membership." (Donham, 1962, p. 64)

To the above list of generally accepted criteria for the differentiation between a profession and any other occupation, this treatise proposes a fifth criterion: the application of professional judgment. This fifth criterion is the infrastructure upon which the other four criteria are built. The knowledge mentioned in criterion one is obtained through criterion three, but it is the exercise of professional judgment that determines which piece of data is appropriate in any given situation. The doctor, for example, analyzes symptoms, diagnoses the disease and prescribes a cure by synthesizing his knowledge of symptoms, diseases and cures.

The use of professional judgment is embodied in criterion two, and it is professional judgment that the organizations mentioned in criterion four are forced to evaluate. It is professional judgment which separates the work of the physician from the work of the carpenter, who must build in accordance with rigid specifications. If it were not for professional judgment, one could develop a scenario under which a carpenter fits all four criteria.

This paper is not alone when it suggests that it is the individual practitioner's exercise of professional judgment that is the key element in professionalism.

> "I believe that our profile of a profession and a professional is now beginning to take shape. We see that a profession itself is built around a boundless body of knowledge, that it is concerned with broad fields of endeavor, that it often deals in concepts and ideas rather than their implementation, and that in many respects it is almost inseparable from the in-

dividuals who practice in it." (Glickauf, 1971, p. 95)

"Accounting principles need not and should not be codified. To introduce such rigidity is to diminish the great service which accountants can and do perform in the interpretation of freely transacted business. There is no reason to believe that accounting and accounting statements should be so simplified as to be readily understandable by one and all. A reasonable man does not expect all persons to understand the intricate details of the practice of medicine without being trained therein. It is equally illogical to expect everyone to fully understand all about accounting. This interpretive function is best left to the accountant.

The demand for uniformity and standardization in accounting systems arises from a distrust of business management. Uniformity and standardization will gain little "since management controls the form which transactions take." Accountants are challenged "to accept their interpretive function and show integrity, courage, and resourcefulness in discharging this function." (May, 1950)

TABLE 1

Selected Dimensions of Professionalism by Citing Author

Dimension	Akers	Barber	Caplow	Carr-Saunders and Wilson	Cogan	Flexner	Foote	Goode	Greenwood	Gross	Lewis and Maude	Pavalko	Vollmer and Mills	Wilensky
Complex Occupation	+	+		+	+	+	+	+	+	+		+	+	+
Self-Employed				+							+			
Person-Oriented				+	+	+		+						
Altruistic Service					+	+		+						
Long Training	+	+		+		+		+	+		+	+		+
Organized	+	+	+	+		+	+	+	+	+	+	+	+	+
Code of Ethics		+	+	+				+	+		+	+		+
Competence Tested				+							+			
Licensed	+		+					+						+
High Income				+				+						
High Prestige		+						+						

Source: Cullen, J.B. *The Structure of Professionalism*, 1978, p. 15.

In the last decade the accounting profession was vigorously attacked. Most of the attacks came from Congress and other branches of the government. Most of the critics have been complaining about the lack of uniformity in financial reporting or the inability of financial reporting to predict business failures. It is ironic that Congressmen, who are mostly attorneys, should lead this fight. There is no profession that has less uniformity or lack of predictability than law. It is possible for the most respected attorneys in the United States, the Justices of the Supreme Court, to have different opinions in the same case which encompasses the same body of facts and is to be judged against the same body of law. In the Supreme Court's last ten decisions in 1979, only three were unanimous. As to lack of predictability, how many times has a client heard from counsel "Here is a case you can't lose," and then lost. It is like the old story about a man who was sued for divorce on the basis of sterility in the morning and sued for paternity in the afternoon and lost both cases.

The accounting profession did not take May's advice and yielded to the pressure from the outsiders. The Financial Accounting Standards Board (FASB) has issued more statements in the last nine years than all of the official pronouncements by the Accounting Principles Board (APB) the previous fourteen years. That does not include pronouncements by the other bodies, both American Institute of Certified Public Accountants (e.g. ASB, AcSec, etc.) and governmental (e.g. SEC, Cost Accounting Standards Board, etc.). Almost all of the pronouncements from FASB and others have been prescriptive in nature. In each case they have been telling the accounting profession what to do and how to do it. In each case, they have been abating the exercise of professional judgment and are therefore seriously eroding the professionalism of the Certified Public Accountant. If this practice continues, it will not be long before a Certified Public Accountant is transformed from a professional to a technician. Berliner and Gerboth have noted the same trends and, with the exception of FASB No. 33, have deplored the situation.

"In many ways, Statement No. 33 represents, if not a clean break, at least a welcome respite from the "cookbook" accounting of the last decade. At least since 1970, the pronouncements of the FASB and its predecessor, the Accounting Principles Board, have increasingly circumscribed the auditor's professional judgment by a seemingly endless flow of specific directives. That tendency reached an extreme with the issuance of FASB Statement No. 13, Accounting for Leases, and the FASB has since seemed disinclined to go that far again. But no deviation from the tendency occurred until Statement No. 33 appeared," Berliner & Gerboth, 1980, p.54)

Worse yet, FASB has not thought through all of the possible alternatives with each pronouncement. Many of the FASB Statements are corrections of or additions to previous FASB statements. In addition, the Board has issued over thirty interpretations in attempts to clarify previously issued FASB Statements. The subsequent statements and interpretations related to FASB No. 13

(Accounting For Leases) comprise a body of literature all their own, yet FASB No.13 remains ambiguous. In 1981 the board of directors of American Institute of Certified Public Accountants (AICPA) appointed a special committee on accounting standards overload and that committee has recommended an immediate reexamination of FASB No. 13, as one of four most troublesome standards issued by the FASB and its predecessor, the APB.

The articles and papers criticizing one or more FASB Statements are too numerous to cite. Thus FASB has been proliferating prescriptive statements at an abnormally fast rate in response to the criticism of outsiders. It is the wrong way to respond to such criticism, and often evokes more criticism. The correct response to the critics of our profession is the same today as it was in 1950 when George O. May said that accounting issues should be solved "in favor of intelligent variation rather than wooden conformity." (May, 1950, p. 210)

Previously, this article enumerated five criteria of professionalism. Number four was "an organization devoted to the advancement of the profession's social obligation and to the enforcement of standards of admission and membership." The AICPA is the organization which establishes and enforces the standards of admission. The Uniform Certified Public Accountant Examination (CPA Exam) is the primary tool that the AICPA uses.

At a recent regional meeting of the American Accounting Association (AAA), there was a discussion of the CPA exam. The general theme of the discussion was that the success rate of the exam was too low. "After all over 80 percent of those sitting for the bar exams pass them," was typical of the comments heard, "as long as the success rate for the CPA exam is less, something is wrong." Nothing could be further from the truth. As stated in criterion four, admission standards to the profession must be maintained. If the standards are lowered, then the quality of the profession and resultant respect will fall. The CPA exam is the screening device that is necessary to assure that only the most qualified enter the profession. The other professions have advanced professional schools which act as the screening device for their profession.

Nevertheless, the AICPA is permitting the CPA exam to become easier by increasing the number of multiple choice questions on the exam. Intuitively, it is obvious that it is easier to answer a question when one of the correct answers is in front of you than it is to answer the same question when you must make up the answer. In fact (assuming four choices), if a multiple choice exam were written in Sanskrit, the average score would be twenty-five.

At that same AAA meeting there were three reasons offered for the increased use of multiple choice questions:

1) it increases the success rate
2) there is a high correlation between the success rate on multiple choice questions and problems or essays
3) it is faster, easier and cheaper to grade multiple choice questions than it is to grade problems or essays. This is necessary because of the growing numbers of applicants.

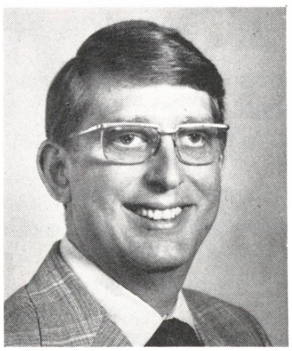
It has already been noted that an increased success rate is not necessarily desirable. Each profession has screening devices which allow only the best to ultimately gain admission into its profession. At the present time, public accounting has the fewest. The most important screening device for the field of public accounting is the CPA Exam.

Part of the accountant's expertise must be the ability to communicate effectively. Many practitioners complain that accounting graduates cannot speak or write and yet, the CPA Exam does little to test for these qualities. The need for essay questions was reaffirmed recently by a State Board Report.

> "... that the Board of Examiners had created a special task force to investigate the use of objective multiple choice questions vs. essay questions. "They concluded that there was a definite need to retain essay questions in areas where a candidate needs to synthesize, integrate, and evaluate information"...." (State Board Report, 1980, p. 117)

The third argument concerning ease and cost of grading is the most offensive. The path of least resistance is always popular but, as described above, the easier marking method will severely and negatively affect the profession. As for the cheaper argument, it is certainly hard to accept a "poor-mouth" statement from an organization with almost fourteen million dollars in cash and marketable securities and a current ratio of 1.58 to 1 (AICPA, 1979, p. 20). No one is ready to accept a cheapening of our profession, especially when there is no need.

Winning the respect of the business community has not been easy for accountants. Maintaining the esteem of the public may well be just as difficult as the earlier thrust toward professionalism. Ω



Edward A. Becker, *CPA, CMA, MBA, is professor of management at Bucknell University, and is a frequent contributor to professional journals. He is a member of AICPA, PICPA, NAA, AAA, and the Academy of Accounting Historians.*

References

Annual Report 1978-1979. *American Institute of Certified Public Accountants* (AICPA, 1979).

Berliner, Robert W. and Gerboth, Dale L. "FASB Statement No. 33 "The Great Experiment," *Journal of Accountancy,* May 1980, p. 48-54.

Cullen, John B. *The Structure of Professionalism* (New York: Petrocelli Books Inc., 1978).

Donham, Paul. "Is Management a Profession?" *Harvard Business Review,* Sept.-Oct. 1962, p. 60-68.

Glickauf, Joseph S. "Footsteps Toward Professionalism," *Footsteps Toward Professionalism* (Chicago, Ill.: Arthur Andersen & Co., 1971).

Larson, Magali Sarfatti. *The Rise of Professionalism, A Sociological Analysis* (Berkeley, Cal.: University of California Press, 1977).

May, George O. "The Choice Before Us," *Journal of Accountancy,* March 1950, p. 206-210.

The Oxford Dictionary of Quotations, 3rd Edition (Oxford, England: Oxford University Press, 1979).

State Board Report, December, 1979. "Ensuring a High Quality CPA Examination," reprinted in *The Accountants Digest,* March 1980, p. 117.

The Tax Penalty On Marriage

An Odious Wedding Gift

By John M. Strefeler

The tax penalty on marriage, or "sin subsidy" as it has sometimes been labeled, is a quirk in the federal tax system that appeared inadvertently as Congress went about its business of amending the Internal Revenue Code. The essence of the problem is that circumstances exist in which a married couple must pay more tax than an identical but unmarried couple would pay on the same quantity of taxable income.

Consider a working couple who each had a 1980 taxable income of $30,000. If they were single individuals, they would each have had a 1980 tax liability of $7,962, and their combined federal income tax would have been $15,924. If they had been married, however, their tax expenses would have increased to $19,678. Some quick arithmetic would show that their wedding present from Uncle Sam would have been a healthy 23.6 percent increase in their tax liability.

The Economic Recovery Tax Act of 1981 has provided for a partial correction of the marriage tax problem, in the form of a special tax deduction which is available to married couples who both work. Reconsidering the previous example but using the tax provisions as they would apply for 1984, a single individual with $30,000 of taxable income would incur a tax of $6,113. Thus, an unmarried couple would have a tax liability of $12,226 if each had $30,000 of taxable income. As a married couple with the same total income, their income tax would amount to $14,028 and they would still suffer a marriage penalty of $1,802. Even after the recent amendments to the tax law, then, this couple would be subject to a 14.7 percent tax increase because of the decision to get married.

Present Situation Of Controversy

The presence of the marriage penalty gained notoriety about six years ago when the news media published stories concerning married couples who were divorcing near the end of the year so they could file tax returns as unmarried individuals, and who would then remarry early in the following year. Such a strategy was designed to take advantage of the tax rule that marital status is determined at the end of the taxable year [Sec. 143 (a) (1)]. A typical case would involve a couple flying to a foreign destination late in the year to get a divorce and to spend the holidays vacationing. They would return home after the first of the year and remarry, paying for the trip with their tax savings. This growing practice and the consequent bad publicity proved to be intolerable to the Internal Revenue Service. In 1976, the IRS indicated in Revenue Ruling 76-255 [1976-2 C.B. 40] that such tax avoidance efforts would not be recognized. The IRS characterized these tactics as sham transactions and argued that a divorce "should not be given any effect for Federal income tax purposes if it merely serves the purpose of tax avoidance."

Recently, the validity of this ruling was contested by a Maryland couple who were assessed back taxes when the IRS refused to recognize their divorce-and-remarriage approach to tax planning [Boyter, 74 T.C. 989]. David and Angela Boyter were among the many married taxpayers to find themselves penalized because of their marital status. In response to this situation, they obtained a divorce in Haiti in December 1975, remarried in Maryland in January 1976, and filed as unmarried taxpayers for 1975. Substantially the same process was repeated one year later, with the divorce this time obtained in the Dominican Republic. Again for 1976 the taxpayers filed as unmarried individuals.

The IRS offered multiple arguments in court as to why the Boyters should be treated as married individuals for tax purposes. The first argument, that Maryland would not recognize these divorces as valid because the foreign courts did not have jurisdiction, was found to be persuasive. Since this argument was dispositive of the issue, the Tax Court did not respond to the other arguments. This is unfortunate as the IRS maintained as another argument that the divorces should be ignored "because a year-end divorce whereby the parties intend to and do in fact remarry early in the next year is a sham transaction . . ." The result of the Boyter case, then, was to narrow the potential path for tax savings through divorce-and-remarriage, but to leave the underlying dispute as to the validity of Rev. Rul. 76-255 unsettled. At least one article has sug-

What caused the tax law's unintended consequences for marriage partners?

gested that the sham transaction doctrine may be ill-suited for applicability to year-end divorces [Michigan Law Review (Editorial Board), 1979].

Meanwhile, the IRS has given its approval to another couple who extended this approach an additional step [Ltr. Rul. 7835076 No. 2956(78) P-H Private Letter Rulings]. This couple was married in 1976 and, although still compatible, they planned to obtain a valid divorce in their state of residence. The only change would be a legal one, since they would continue to live together and to carry on their life just as they had before. The sole reason for their divorce was the potential tax savings, but the IRS nevertheless accepted the tax implications of their intended course of action. Since the divorce would remain in effect for all legal purposes, it could not be construed as a sham and the IRS found no basis upon which to deny unmarried status to the couple.

Such legal maneuvering seems incredible in the absence of any Congressional intent to influence personal decisions regarding marriage. How, then, can one account for this unintended consequence of the federal income tax? The answer seems to lie in two historical developments — one involving the tax system itself and the other concerning the increasing number of two income families in the American economy.

History Leading To The Current Situation

Until 1948, marital status was relatively unimportant because everyone used the same set of tax rates. The assumptions on which the tax system was based (that the individual should be the basic taxpaying entity and that differing family situations could be amply provided for through the use of exemptions) had seemed to work well. One reason for this success may have been that prior to World War II the exemption was viewed as a vehicle to exclude from taxation enough income to provide adequate support for a family. The resulting high dollar amount of exemptions meant that only a small percentage of the population was affected by the income tax.

After World War II, a major inequity in what had grown into an all pervasive income tax became evident. The single tax rate system provided an unintended tax advantage to taxpayers who resided in community property states.[1]

In common law states, income is attributed to the individual who performs the services or who owns the property which is responsible for the income generation. The typical situation in the 1940's was for the husband to be the breadwinner of the family and for the wife to be the homemaker. Thus, whether the married couple filed a joint return or separate returns, all of the income would go on one return and be subject to the full brunt of the progressive tax rates.

In contrast, income in community property states is earned equally by marriage partners regardless of which spouse actually performed the services. Income generated by community property would also be allocated equally to husband and wife. The result was that married couples in community property states could save taxes by filing separate returns, with each reporting one-half of the total income. They would have the advantage of moving through the lower tax brackets twice — once on each return.

This lesson was not lost on the American taxpayer. Residents of common law states turned to their state legislatures and soon a number of common law states (Oklahoma and Michigan, for example) were in the process of changing their property rights laws. This unintended effect of the tax system led Congress to enact a provision in the Revenue Act of 1948 which allowed married taxpayers filing joint returns to split their income, thus giving the advantage of income splitting to all taxpayers regardless of their state of residence.

The other change in the tax law which filled in the missing piece to create the marriage penalty began to unfold in 1969. Unmarried taxpayers appealed to Congress concerning the differential in tax rates which existed between single and married taxpayers. At that time, a single person could pay up to 41 percent more tax than a married couple with the same total income. Congress responded by lowering the rates for single taxpayers effective in 1971; the new rates limited the excess that a single individual would pay to 20 percent above the tax of a married couple. Furthermore, to prevent married persons from frustrating the intent of the law by electing to file separately and use the new rates for singles, Congress limited the new Schedule X to single taxpayers. Married persons were required to continue to use Schedule Y, with separate rate structures for joint returns and separate returns. Thus, the single and married-filing-separately rate structures were no longer combined and the marriage penalty appeared.

Emergence Of The Two-Income Family[2]

While the tax system was evolving so that the potential of a marriage tax was present, changes in American society made the marriage tax more widespread in its application. The primary change has been the increasing number and percentage of wives in the labor force. In 1950, 8.5 million wives were in the labor force, representing a labor force participation rate[3] of 23.8 percent [Schiffman, 1960]. By contrast, the number of working wives in 1979 totaled 23.8 million for a participation rate of 49.4 percent [Johnson, 1980].

[1]Most states were common law states; that is, they derived their legal code from English common law. Eight states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington) based their property rights instead on community property rules.

[2]The author acknowledges the detailed work of Alan Hee, University of Hawaii graduate assistant, in researching and helping to write this section.

[3]Labor force participation rate = number of married women (husband present in the household) in the labor force divided by the civilian poulation of married women (husband present).

TABLE 1

Marriage Bonus (+) And Marriage Penalty (−) Under ERTA (1980) Tax Provisions

WIFE'S ADJUSTED GROSS INCOME											
50,000	+3,344	+1,144	−379	−1,691	−2,699	−3,474	−4,014	−4,314	−4,369	−4,394	−4,394
45,000	+3,126	+1,094	−429	−1,711	−2,699	−3,474	−4,014	−4,314	−4,369	−4,394	−4,394
40,000	+2,801	+901	−454	−1,736	−2,694	−3,449	−3,989	−4,289	−4,344	−4,369	−4,369
35,000	+2,374	+606	−617	−1,731	−2,689	−3,414	−3,934	−4,234	−4,289	−4,314	−4,314
30,000	+1,929	+424	−667	−1,649	−2,439	−3,164	−3,654	−3,934	−3,989	−4,014	−4,014
25,000	+1,505	+219	−609	−1,459	−2,117	−2,674	−3,164	−3,414	−3,449	−3,474	−3,474
20,000	+1,092	+30	−579	−1,166	−1,692	−2,117	−2,439	−2,689	−2,694	−2,699	−2,699
15,000	+710	−150	−535	−903	−1,166	−1,459	−1,649	−1,731	−1,736	−1,711	−1,691
10,000	+475	−208	−391	−535	−579	−609	−667	−617	−454	−429	−379
5,000	+250	−202	−208	−150	+30	+219	+424	+606	+901	+1,094	+1,144
0	+0	+250	+475	+710	+1,092	+1,505	+1,929	+2,374	+2,801	+3,126	+3,344
	0	**5,000**	**10,000**	**15,000**	**20,000**	**25,000**	**30,000**	**35,000**	**40,000**	**45,000**	**50,000**

HUSBAND'S ADJUSTED GROSS INCOME

Table assumes no dependents and that deductions are not itemized

The increase in two-earner families is partially due to the failure of real income to maintain the growth rate which had occurred in the early post-war period. Between 1947 and 1962, the annual real wage gain averaged about 2.5 percent, almost three times the annual increase in the years since 1962. The erosion is attributable to the decline in productivity rates among American workers and to the sharp increase in inflation over this period [Douty, 1977]. The continuation of these trends seem certain to make the two-income family an increasingly common fixture in American society.

Another factor which influences the labor participation rate among wives is the presence of children. Wives are more likely to work if there are no school-age or pre-school children in the household. Following World War II, many married women were involved in caring for children during this period of high birth rates. Beginning in the late 1960's, however, the number of working wives accelerated. This trend continued during the 1970's as declining birth rates resulted in fewer children to raise. Thus, the changing character of the family household explains much of the increase in working wives [Slater, 1979].

Dimension Of The Marriage Penalty Prior To ERTA

All married couples have not suffered the burden of the marriage tax. When all or the vast proportion of income was generated by one of the parties, there was no penalty and in fact there was a tax savings. This is seen for 1980 as the positive zone of Table 1. A tax savings of $2,801 existed, for example, if a married couple had $40,000 of taxable income which was generated entirely by one spouse.

On the other hand, Table 1 also reveals that the marriage penalty was not limited to a narrow income range and that the amount of tax differential could be substantial. The two-career family would fall into the penalty area in almost every instance. If the previous example were altered by assuming that the income was equally divided between the spouses, the tax savings would be replaced by a $1,692 penalty.

Table 2 provides additional detail about the situation in which both incomes were equal, which was where the marriage penalty was most extreme. In particular, it emphasizes how broad and deep the marriage tax had become. The penalty is already evident at the $4,000 level of taxable income. Two single persons splitting this income would have had no tax liability, while a married couple would have owed $84 of income taxes. At a taxable income of $84,000 the marriage tax reached its maximum for wages and other forms of personal service income; a married

TABLE 2

Marriage Penalty Under Pre-ERTA (1980) Tax Provisions For Couples With Equal Incomes

Total Taxable Income	Marriage Penalty	Married Tax As a percent of Unmarried Tax
$100,000	$4,394	112
92,000	4,394	114
84,000	4,394	116
76,000	4,324	119
68,000	4,234	122
60,000	3,754	124
52,000	3,074	124
44,000	2,232	123
36,000	1,496	121
28,000	903	119
20,000	451	116
12,000	221	118
4,000	84	—

couple would have paid $4,394 of additional taxes.[4]

Causes Of The Marriage Penalty

The primary cause of the marriage tax has been the differentiating among taxpayers by means of the tax rate structure; married couples have been denied use of the same tax rates as were available to unmarried taxpayers. They must instead use either the married-filing-separately schedule in which the progressive rates rise more rapidly, or use the married-filing jointly schedule which has brackets twice as wide but which taxes the income as one bundle and thus stacks the income of one spouse on top of the income of the other.

A contributing factor has been the standard deduction. A single individual may take a standard deduction (now called the zero bracket amount) of $2,300; two unmarried individuals would receive twice this amount, or $4,600, on their two returns. Were they married, they could take a combined standard deduction of only $3,400. Thus, being married could deprive a couple of $1,200 of deductions to which they would otherwise be entitled. This factor is unimportant to taxpayers who itemize deductions, but well over half of all taxpayers do not itemize.

Effects Of The Marriage Penalty

While there is no indication that Congress intended to influence marital decisions through tax provisions, several consequences derive from the lack of tax neutrality with respect to marital status.

One consequence of a marriage penalty is that it provides a disincentive to marry and an incentive for married persons to divorce. How many of the small but growing number of couples who are unmarried and living together considered the marriage tax as one of their decision factors is unknown, but the financial implications can be substantial. It is also evident that those taxpayers who do forsake marriage for tax reasons have been very visible.

Another effect of a marriage penalty is that it operates as a work disincentive for married women relative to those who are single. The married woman finds that her income is added to that of her husband and, while the tax brackets that she faces are twice as wide as those of her single counterpart, she does not receive the advantage of going through the lower brackets. Other things being equal, her after-tax earnings are lower than those of a single woman.

As an example, suppose two women were offered jobs with 1980 salaries of $20,000. Circumstances were identical except that one woman was married to a man who earned a taxable income of $20,000 per year, while the other was unmarried and claimed the standard deduction. For the unmarried woman there would have been a $3,415 tax levied, while the tax on the income of her married counterpart would have been $7,001. The tax for the married woman thus would have been over twice the tax for the single women.

A third consequence is the risk that tax situations such as a marriage penalty may undermine the perceived equity of the tax system and reduce the level of voluntary compliance. For those taxpayers who cannot or who choose not to use the marriage tax to their advantage, the knowledge that others take advantage of the tax system in this contrived manner may cause them to regard the system as unfair. It is easy to envision such taxpayers cutting corners in other ways — unreported income and overstated deductions, for example — to even things out.

Treatment Of The Marriage Penalty — ERTA Changes

The approach to the problem of the marriage tax which was implemented by the Economic Recovery Tax Act of 1981 is the provision of a deduction based upon the qualified earned income[5] of the secondary

[4]Prior to 1981, the maximum tax rules gave a preference to personal service income. Personal service income was subject to a maximum marginal rate of 50 percent. Other income could be taxed at rates as high as 70 percent, which would have caused the marriage penalty to be even greater. For a married couple with $100,000 of income which was not personal service income, for example, the marriage penalty would have been $5,864 if the income were earned equally. The pre-1981 examples in this article assume personal service income as a matter of simplicity. The Economic Recovery Act of 1981 lowered the top tax bracket to 50 percent for all income, thus ending the tax distinction between personal service income and passive income.

wage earner, such person being defined as the spouse who has the lesser amount of earnings in a particular year. This new deduction, allowed by new Sec. 221 of the Code, will be an adjustment to gross income and thus available even for taxpayers who do not itemize their deductions. The deduction will equal five percent of the qualified earned income of the secondary wage earner in 1982, with a $30,000 limit on eligible qualified earned income. For years after 1982, the deduction will increase from five to ten percent of qualified earned income. The $30,000 ceiling will remain in effect, so that the maximum deduction will be $1,500 in 1982 and $3,000 for all subsequent years.

Using a deduction as the vehicle for alleviating the tax on the earnings of the secondary wage earner is relatively simple and directly addresses the problem of the tax treatment of secondary family income. Table 3 shows the status of the marriage penalty for 1984, the first year that the full tax deductions under ERTA will be in effect; a comparison with Table 1 indicates the changes which will result. Obviously a deduction of this sort will reduce but not eliminate the tax penalty on marriage. For example, the penalty on a married couple who each have adjusted gross incomes of $30,000 would be reduced from $3,654 to $1,722 or by a total of $1,932.

A possible criticism of the deduction method is that it is not an even reduction for all two-earner couples. Since a deduction is beneficial in accordance with the marginal tax rates of taxpayers, the secondary income deduction is of more value to married couples with higher incomes. While the married couple splitting $60,000 of income in the previous example was able to save $1,932, a couple evenly dividing $40,000 of adjusted gross income would gain only $1,044 in tax relief. In response to this criticism, however, it should be noted that the marriage penalty itself is most severe for high-income families. Applying a judgment criterion of vertical equity does not seem appropriate, as the purpose of the provision is to seek equity in a different form — namely between two-earner married couples and two-earner unmarried couples. It may thus be argued that tax relief should be unequal since the underlying problem penalizes families unequally.

A further criticism of a deduction is that it does not resolve the underlying issue of marriage neutrality. Both the marriage penalty and the marriage bonus continue to exist. Again looking at Tables 1 and 3, one can see that there has been no appreciable change in the scope of the marriage tax. The size of the marriage penalty has shrunk, but the penalty continues to occur in all of the squares where it had occurred prior to ERTA. A deduction, therefore, does not involve a theoretically consistent tax policy regarding the treatment of marital status. Sometimes couples are rewarded for being married; at other times they are penalized.

In defense of the deduction approach to alleviating the tax penalty on marriage, however, there is no simple proposal which would not suffer from significant drawbacks. An alternative which has a great deal of surface appeal, for example, is to allow married couples to file separate tax returns and use the tax rate schedule (and other tax rules) for single taxpayers. Such an elective filing technique would directly attack the objectionable symptom of the current tax system; married couples would be relieved of the marriage penalty by being allowed to use the tax rules for unmarried persons.

Unfortunately, this procedure would resurrect the inequitable treatment of unmarried persons. Consider a married couple with a 1984 taxable income of $40,000 divided equally between them. Their tax, if they each were to file as single persons, would total $6,410. An unmarried individual with $40,000 of taxable income would incur a tax of $9,749, an amount 52 percent higher than the tax of the married couple. This situation appears unacceptable when one recalls that in 1969 Congress found a 41 percent difference to be objectionable.

Special deductions do not resolve the underlying issue of marriage neutrality.

Also, allowing married couples the option of filing separately is a one-sided solution to the issue. The marriage penalty is erased, but marriage neutrality has not been achieved. The married couple whose income is derived entirely (or almost entirely) from one spouse would still enjoy a marriage bonus.

Another drawback of this proposal is that it would add complexity to the tax return preparation process. Many couples would have to compute their taxes both ways to determine whether they would receive more advantage from income splitting on a joint return or from using the same standards as single persons. This would involve three computations — one for each spouse separately and one for the couple if they were to file jointly.

In the final analysis, then, the attractiveness of the two-earner deduction is in its short-run and practical results rather than in a long-run theoretical justification. It reduces the marriage penalty immediately and leaves a more consuming treatment of the issue to the future. One might regard it as a companion to the relief of the single taxpayer which was enacted as part of the Tax Reform Act of 1969. Just as that legislation dealt with the singles tax penalty not eliminating it but by reducing it to bounds which Congress considered to be tolerable, so too the current deduction decreases the size of the marriage tax to what proponents might argue to be an acceptable level.

Conclusion

The essence of the marriage penalty is that in some situations a

[5]Qualified earned income is technically defined in ERTA. For example, it does not include retirement plan distributions, deferred compensation, or certain wages when one spouse is employed by the other. Also, community property laws are ignored so that earned income is attrributed to the spouse who actually performs the services to earn the income.

TABLE 3

Marriage Bonus (+) And Marriage Penalty (−) Under ERTA (1984) Tax Provisions

WIFE'S ADJUSTED GROSS INCOME											
50,000	+ 2,861	+ 1,344	+ 356	− 528	− 1,274	− 1,844	− 2,226	− 2,630	− 2,830	− 3,062	− 3,212
45,000	+ 2,521	+ 1,144	+ 156	− 668	− 1,274	− 1,844	− 2,226	− 2,630	− 2,830	− 2,930	− 3,062
40,000	+ 2,171	+ 879	+ 56	− 768	− 1,334	− 1,744	− 2,126	− 2,530	− 2,730	− 2,830	− 2,830
35,000	+ 1,727	+ 629	− 134	− 768	− 1,334	− 1,724	− 1,946	− 2,330	− 2,530	− 2,630	− 2,630
30,000	+ 1,458	+ 448	− 180	− 779	− 1,130	− 1,520	− 1,722	− 1,946	− 2,126	− 2,226	− 2,226
25,000	+ 1,152	+ 268	− 198	− 670	− 978	− 1,143	− 1,520	− 1,724	− 1,744	− 1,844	− 1,844
20,000	+ 844	+ 135	− 205	− 492	− 648	− 978	− 1,130	− 1,334	− 1,334	− 1,274	− 1,274
15,000	+ 540	− 17	− 177	− 338	− 492	− 670	− 779	− 768	− 768	− 668	− 528
10,000	+ 376	− 73	− 91	− 177	− 205	− 198	− 180	− 134	− 56	− 156	− 356
5,000	+ 193	− 85	− 73	− 85	+ 135	+ 268	+ 448	+ 629	+ 879	+ 1,144	+ 1,344
0	+ 0	+ 193	+ 376	+ 540	+ 844	+ 1,152	+ 1,458	+ 1,727	+ 2,171	+ 2,521	+ 2,861
	0	**5,000**	**10,000**	**15,000**	**20,000**	**25,000**	**30,000**	**35,000**	**40,000**	**45,000**	**50,000**

HUSBAND'S ADJUSTED GROSS INCOME

Table assumes no dependents and that deductions are not itemized;
AGI figures are before the new two-earner deduction (to be consistent with Table 1)

couple pays more taxes by filing as a married couple than they would pay if they were to file as two single individuals. This unintended result of congressional tax changes has caused some couples to turn to divorce-and-remarriage or to divorce-and-living-together as a means of tax savings, with the latter technique being less risky in light of current IRS policy.

Some of the aspects of the marriage tax which have made revision desirable are the disincentive for taxpayers to get or to remain married, the disincentive for married women to work outside of the home, and the threat to the fairness of and respect for the tax system.

To alleviate the problem of the tax penalty on marriage, Congress enacted a two-earner deduction as part of the Economic Recovery Tax Act of 1981. This provision will, when fully phased in 1983, grant a 10 percent deduction on the first $30,000 of earnings of the secondary wage earner. While not a comprehensive cure which eliminates the underlying ailment, it is a treatment which relieves the most serious symptom until a more thorough approach to the issue can be mounted. As one author has noted somewhat philosophically, "we cannot ignore the opportunity to make small but positive changes while waiting for a massive tax reform which may never come." [Rosen, 1977.]. Ω

REFERENCES

Douty, H.M. "The Slowdown in Real Wages: A Postwar Perspective." *Monthly Labor Review* (Volume 100, August 1977), pp. 7 - 12.

Johnson, Beverly. "Marital and Family Characteristics of the Labor Force, March 1979." *Monthly Labor Review* (Volume 103, April 1980), pp. 48 - 52.

Michigan Law Review (Editorial Board). "The Haitian Vacation: The Applicability of Sham Doctrine to Year-end Divorces. *Michigan Law Review* (Vol. 77, No. 5, pp. 1332 - 1354.

Rosen, Harvey S. "Is It Time to Abandon Joint Filing?" *National Tax Journal* Vol. XXX, No. 4), pp. 423 - 438.

Schiffman, Jacob. "Family Characteristics of Workers, 1959." *Monthly Labor Review* (Volume 83, August 1960), pp. 828 - 836.

Slater, Courtenay, "Statistics Reveal Three Distinct Phases in Growth of Women in Labor Force." *Business America* (Volume 2, March 26, 1979), pp. 20 - 21.

John M. Strefeler, *CPA, Ph.D., is associate professor of accounting at the University of Nevada-Reno. He was formerly with the faculty of the University of Hawaii, and holds membership in AAA, NAA, and the National Tax Association-Tax Institute of America.*

Practical Experience For Accounting Educators

What Are The Problems?

By Abdel M. Agami, Ula K. Motekat, and Stanley E. Warner, Jr.

In April 1982 the first accounting programs were accredited by the American Assembly of Collegiate Schools of Business (AACSB). While the standards used to evaluate accounting programs are, by and large, similar to the standards used to judge business programs, one of the new standards for accounting programs is different and unique: it is the professional experience requirement. In its interpretation of this standard, the AACSB states:

> A significant proportion of all faculty should strive to obtain relevant professional accounting experience regularly throughout their professional careers. "Regularly" means at lest sixty days of experience within the most recent five-year period. "Relevant" means the experience should be related to the subject matter content of the courses generally taught by the faculty member.
>
> Such experience may include, but is not limited to, 1) consulting with and employment by business, public accounting, governmental and other not-for-profit organizations, 2) serving on technical committees of professional and academic organizations, 3) serving on boards of directors, and 4) developing case material which involves substantial exposure to practice problems of the accounting profession. [AACSB, 1981]

Since the accreditation process can work only if enough faculty members satisfy this requirement, the authors decided to find out whether accounting educators are willing to meet this standard.

THE RESEARCH DESIGN

A questionnaire was chosen as an appropriate method of obtaining the faculty's reaction to the experience standard. To get a representative sample the questionnaire was mailed to 525 accounting faculty members (approximately ten percent) chosen randomly from Hasselback's *Accounting Faculty Directory 1980-81*. [Hasselback, 1981] By the cut-off date usable responses had been received from 215 faculty members, a response rate of forty-one percent.

In order to determine whether the respondents were a fair representation of the sample, the two groups were compared on the basis of certain characteristics listed in the *Directory*. Table 1 shows this comparison. It can be seen from this table that, with two exceptions, the rates of response are clustered around the overall rate of forty-one percent. The two exceptions are the responses from women and from holders of professional certificates. In both cases, the number of people with the characteristic was probably undercounted in the sample. In the case of sex, an addressee was classified as female only if the first name was given in the *Directory* and was unequivocably female. A person listed with a first named used by both sexes, with an unusual first name, or with initials only was therefore classified as male. In the case of professional certification, the *Directory* probably omitted this fact for faculty recently certified.

The questionnaire consisted of two parts. The first part asked faculty members whether they were interested in obtaining professional experience and, if so, how they would like to do it. These questions were designed to find out not only for whom professors want to work, but also what kind of work they want to do, when they want to do it, and how much remuneration they expect. The second part of the questionnaire asked for personal data from the respondents. These questions were included to see whether differences in responses could be attributed to certain characteristics such as rank, age, sex, publication record, previous accounting employment, teaching areas, etc.

THE SURVEY RESULTS

Of the 215 respondents to the survey, 147, or well over two-thirds, expressed an interest in working for a CPA firm to satisfy their relevant professional experience requirement. Of these 147, fifteen female and ninety-three male faculty members (fifty percent of all respondents) ranked employment by a CPA firm as their first choice for employment. This response surely is an indication that a sizable proportion of accounting educators will look to the public accounting profession for help in acquiring relevant accounting experience. To assist the profession in meeting this demand, this article describes the responses by the 108

TABLE 1

Rates of Response by Rank, Sex, Professional Certificate and Teaching Institution

	Sample		Respondents		Rate of Response
	n = 525		n = 215		41%
Rank:	n	%	n	%	%
Professor	165	31	66	31	40
Associate Professor	122	23	58	27	48
Assistant Professor	155	30	70	32	45
Instructor, Lecturer, etc.	83	16	21	10	25
Sex:					
Male	472	90	184	86	39
Female	53	10	30	14	57
No answer			1		
Holders of CPA/CMA Certificates:	332	63	163	76	49
Faculty Teaching at:					
AACSB Accredited Schools					
with doctoral programs	132	25	55	25	42
without doctoral programs	228	43	98	46	43
Total at Accredited Schools	360	68	153	71	42.5
Non-Accredited Schools	165	32	62	29	38

TABLE 2

Previous Accounting Experience of 108 Respondents

	No Previous Experience with CPA Firms	Previous Full and/or Part-time Experience with CPA Firms
Previous Experience in:		
Self-employment	1	4
Consulting only	4	10
Business only	7	7
Business and consulting	3	13
Business and self-employment	1	2
Consulting and self-employment	5	13
Business, consulting, and self-employment	7	10
Respondents with Other Previous Experience	28	59
Respondents with no Other Previous Experience	10	11
Total Respondents	38	70

faculty members and examines the implication for the prospective employers. This will be done by answering, in turn, the questions: Who wants to work for CPA firms? What do they want to do? When do they want to work? What compensation do they expect, and for what firms to they want to work?

Who Wants to Work for CPA Firms?

According to the survey results, the professional background of the 108 respondents is compatible with their employment interest. Over three-fourths have CPA Certificates, and the majority have previously worked for CPA firms, either part-time, full-time, or both, as Table 2 shows. It can also be seen from this table that only ten percent have no previous accounting experience whatsoever, whereas well over half have two or more kinds of accounting experience. The previous accounting experience of the fifteen women follows the pattern of the men and is therefore not shown separately.

This variety of previous accounting experience means that some faculty members may have had expiences which regular staff members in CPA firms lack, whereas others are less qualified than junior staff members. Schedulers used to professional staff with a known and predictable level of experience will have to pay special attention when assigning faculty to jobs.

If the Cohen Commission Report was correct in seeing a widening schism between academia and the accounting profession [AICPA, 1978], the results of this survey should be encouraging to both academic and public accountants. The 108 respondents primarily interested in working in CPA firms tend to be younger and in lower academic ranks than all respondents, raising the hope that through their employment in CPA firms they will help to bridge the schism. While the women are slightly younger than the men, almost half (sixty percent of the women and forty-six percent of the men) are under age forty, and over four-fifths are under age fifty. Only twenty-two percent of this group are full professors, whereas thirty-one percent of all respondents are in the higher academic rank.

Sixty-two percent have a doctoral degree; eight percent are ABD.

The scholarly output, as measured by presentations of papers at professional meetings and publications in professional journals, is somewhat less for the 108 respondents interested in CPA employment than for the 215 respondents as a whole. About thirty percent have less than six publications and no presentations, and another forty percent have less than six publications and/or presentations. This low scholarly output is understandable since the 108 respondents tend to be in the lower academic ranks, and scholarly output is closely associated with academic rank. Of those with no scholarly output, seventy-seven percent are below the associate professor level and eighty percent are below the full professor level. On the other hand, almost ninety percent of those with high scholarly output are associate or full professors.

For the female respondents, too scholarly output and academic rank are correlated. Since the women in this group tend to be younger and in lower academic ranks than the men. their scholarly output is lower.

The age, academic rank, and education of the 108 faculty members point to a potentially serious problem when they work for a CPA firm. Their lack of previous experience may result in their being supervised by staff members much younger and less educated than they are. How will the professors and the staff members react to these delicate situations?

What Do They Want To Do?

Specifically, do the 108 faculty members want to broaden or deepen their accounting knowledge while working in a CPA firm? The answer is: both. Although most of them want to do what they teach, they also want to work in areas where they have not taught, as Table 3 shows. The table also shows that virtually all faculty members are flexible and interested in working in more than one area.

Since the areas in which accounting educators want to work will play a major role in faculty assignment by CPA firms, this section will take a closer look at five areas: auditing, taxes, systems, professional development, and research.

TABLE 3

Teaching Areas and Work Interests of 108 Respondents

	Teaching Areas				
	Financial n=85	**Cost** n=51	**Audit** n=29	**Systems** n=12	**Tax** n=33
Working Interests:					
Financial (n=88)	81	43	24	8	23
Cost (n=51)	42	29	13	6	12
Auditing (n=61)	52	24	26	6	9
Systems (n=43)	24	12	6	2	5
Taxes (n=54)	41	23	10	2	32

Auditing

Since CPA firms are best known for their auditing function, it is understandable that the majority of the 108 respondents want to do auditing. What is surprising is that over one-fourth do not. Their work preferences are shown in Table 4.

It is also noteworthy that of the 61 faculty members who want to work in auditing, only 26 teach auditing now, or have taught it in the past. Unless the other 35 educators plan to teach auditing in the future, they may find that working as auditors does not qualify as "relevant" professional experience for them, since the AACSB may interpret "relevance" to denote a direct relationship between the work done and the subjects taught.

If some or all of these 35 educators plan to teach auditing in the future, they provide the CPA firms with a unique opportunity: the firms can show the future auditing teachers through actual cases what knowledge they would like to see in the graduating students they will recruit in the future.

The 29 faculty members who teach auditing are probably of particular interest to CPA firms. Their work preferences are shown in Table 5. It shows that, although their first choice is auditing, they are very flexible and would also like to work in other areas. An interesting fact is that six of these 29 auditing teachers have never worked in CPA firms.

Taxes

Table 3 shows that of the 108 respondents, 33 teach taxes (thirty-one percent), 54 want to work in taxes (fifty percent), and 32 of the tax professors want to work in the tax area. CPA firms may be able to assign these 32 tax professors to planning research, or return preparation in their tax departments. But the 22 professors who have not taught taxes and yet are interested in tax work raise two important questions: (1) Can the CPA firms find meaningful work for them? And, (2) if so, will such work qualify as relevant experience for non-tax professors?

Systems

Only 12 of the 108 faculty members (eleven percent) teach systems, as Table 3 shows, while 43 want to work in systems (forty percent). Only two

TABLE 4

Work Preferences of 28 Faculty Members Not Interested in Audit Work

Work Preference	Number of Faculty Members
Taxes	22
Professional Development	22
Financial Accounting	21
Research	10
Managerial Accounting	4
Systems	1

TABLE 5

Work Preference of 29 Respondents Who Have Taught Auditing

Work Preference	Number of Faculty Members
Auditing	26
Financial Accounting	24
Professional Development	19
Taxes	10
Managerial Accounting	8
Research	8
Systems	4

of the twelve systems professors want to work in their teaching area, the lowest proportion for any teaching area. The 41 professors who do not teach systems but are interested in working in that area raise the same two questions as the 22 nontax professors discussed previously about availability of meaningful work and qualification of the work as relevant experience.

The preceding descriptions of the teaching areas and work interests of the 108 faculty members highlight the problems the professors and the CPA firms may have to face in working together. On the one hand, these faculty members are flexible in their work interests, enabling the firms to assign them to a variety of tasks. On the other hand, many faculty members would like to work in areas in which they have never taught or worked, probably necessitating a lot of on-the-job training by the employing CPA firms and running the risk that such employment will not qualify as relevant professional experience for the faculty member.

Professional Development

Of the 108 respondents, 76 want to work in professional development (seventy percent). This high positive rsponse is probably due to two factors: (1) faculty may feel most comfortable offering their services in this area, because conducting professional development seminars closely resembles classroom teaching, and (2) the respondents may have thought that they could offer a valuable service, expecially to small CPA firms who lack enough personnel to allow a high-ranking member of the firm to concentrate on new developments in accounting and taxes. These firms could, instead hire accounting teachers who must keep up with new developments in their teaching areas and could therefore keep the professional staff up-to-date.

It should probably be pointed out that only the preparation of the professional development seminars will qualify as relevant professional experience, the mere running of the seminars will not. The reason may be that the educators do not learn anything about practical accounting problems if they simply transfer their theoretical knowledge to their public accounting audience in these seminars. To meet the professional experience requirement, professors may have to familiarize themselves with the firm's clients and their practical problems and then present their findings and solutions like case studies in their professional development seminars.

Research

Of the 108 faculty members, 74 expressed an interest in doing research while working in CPA firms (sixty-nine percent). The majority of these 74 educators, as Table 6 shows, have little or no scholarly output as measured by presentations of technical papers and publication of articles.

The high interest in doing research, coupled with the low scholarly output, points out a potential problem. Given the emphasis on scholarly research in universities, these faculty members may want to do research which will lead to publications and presentations. The CPA firms, on the other hand, may want them to solve practical problems arising during the course of an engagement which are not suitable for publication.

At the same time, the faculty's interest in doing research presents CPA firms with the opportunity to influence future research topics by guiding the faculty members working for them into researching practical problems and away from more esoteric research areas.

When Do They Want To Work?

Employing faculty on a temporary basis will pose problems for CPA firms who must staff engagements over a period of time. However, the faculty members interested in working for CPA firms show a surprising flexibility which should reduce the difficulties of work assignment. Ninety-five of them (eighty-eight percent) will work during the summer, giving their employers an extended period of time, unfortunately during the slack season. Ninety-nine (ninety-two percent) will work while on sabbatical or unpaid leave, resulting in an even longer working association. However, not all universities grant paid sabbatical leaves, and unpaid leave may require higher compensation of faculty. Fifty-seven of them (fifty-three percent) will work regularly during the semester, for instance one day a week, thus providing continuity in their association with the CPA firm but raising questions about the type of engagement which can be carried out during only a few hours a week. Finally, forty-five faculty members (forty-two percent) will work during vacations, other than the summer break, enabling CPA firms to use them on engagements of short duration. If these vacations include the month of January, as is becoming common, CPA firms can get temporary faculty help during their busy season.

Only five percent of the 108 faculty members limit themselves to working only while on leave or during the summer; all others are willing to work at various times during the year. This flexibility on the part of the accounting educators should help their prospective employers in scheduling their work assignments.

What Compensation Do They Expect?

It is obvious that faculty members would be happy if CPA firms compensated them for their time at a higher rate than their univiersities. When asked whether expense reimbursement alone would be sufficient, eighty-four percent said no. Clearly, some compensation is expected. Most of them expect this compensation level to be at or above their academic salary, but a surprising 28 of them, including seven women, are willing to work for less than their academic rate of pay. The findings that some faculty are willing to work for expense reimbursement only and that over a fourth of them are willing to work for less than their academic salary shows that many faculty members are willing to make a significant financial sacrifice to obtain professional experience.

What Firms Do They Want To Work For?

The surprising answer is: not only for the Big 8. In fact, less than one-fourth (twenty-two percent) would limit themselves to working for large, national firms. Over one-half (fifty-four percent) of both the men and the women responded favorably toward working for small, local firms. The implication of these responses is that small, local firms cannot assume that the large national firms alone will have the responsibility for providing relevant accounting experience. The few large firms cannot possible accommodate the large number of faculty who will be looking for public accounting experience. The small firms will therefore have to share the responsibility and, fortunately, many faculty members would like to work for them.

TABLE 6

Scholarly Output of 74 Respondents Interested in Research

Presentations at Professional Meetings	Published Articles: None	1 - 5	6 - 10	Over 10	Total
None	15	4			19
1 - 5	7	19	4	1	31
6 - 10		7	2	2	11
Over 10		2	2	9	13
Total	22	42	8	12	74

CONCLUSION

The answers to the previous questions show that faculty are interested in acquiring relevant accounting experience by working for CPA firms and that they are flexible in when they will work and what kind of work they will do. But the public accountant may still have one question: will accounting professors view their work with CPA firms as an integral part of their academic careers? The answer is a resounding yes. Over one-half (fifty-one percent) believe the CPA firm's evaluation of their performance should be furnished to their academic departments. But beyond that, forty-eight percent believe it should influence their raises, and over three-fourths (seventy-six percent) believe it should affect promotion decisions.

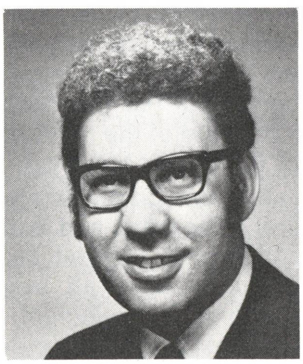
Finally, both academic and public accountants may wonder whether working for a CPA firm will have an impact on the faculty's research and teaching. Certainly, that is the faculty's expectation. Sixty percent felt it should be relevant to their research, while eighty-eight percent felt it should be relevant to their teaching. If the public accounting profession can meet these expectations, practice and education will meet, both in research and in the classroom. Ω

REFERENCES

American Assembly of Collegiate Schools of Business. *Accreditation Council Policies, Procedures and Standards, 1981-1982.* St. Louis, Missouri: AACSB, 1981, p. 41.

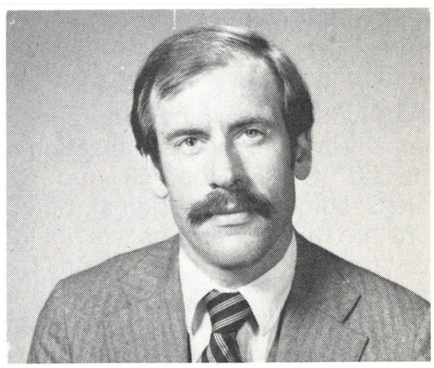
American Institute of Certified Public Accountants. *Report of the Commission on Auditors' Responsibilities.* New York: AICPA, 1978, Section 8, pp. 85-92 (known as the Cohen Commission Report).

Hasselback, James R. *Accounting Faculty Directory 1980-81.* Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1981.



Abdel M. Agami, CPA, Ph.D., *is professor of accounting at Old Dominion University. He is a certified public accountant in New York and Virginia, and is a member of AAA, AICPA, NAA, NYSSCPAs, and VSCPAs. He is an earlier contributor to The Woman CPA, and has been published in other academic and professional journals.*

Ula K. Motekat, CPA, DBA, *is professor of accounting at Old Dominion University. She is a member of AWSCPA, ASWA, AICPA, and AAA. Dr. Motekat is a former editor of The Woman CPA, and presently serves this publication as column editor for the International Accounting Department.*



Stanley E. Warner, Jr., CPA, Ph.D., *is associate professor of accounting at Old Dominion University in Norfolk. He is a member of the American Accounting Association and has been published in various academic and professional journals.*

A Reconsideration of Capitalizing Interest Costs

An Even 'Closer Look'

By Donna A. Dingus and Roland L. Madison

The fall of 1979 saw the issuance of two very controversial standards by the Financial Accounting Standards Board (FASB). These were Statements No. 33 and No. 34. This discussion is confined to the latter Statement since a wealth of empirical evidence about the problems encountered with the inflation accounting statement (SFAS No. 33) is being published in the literature, and SFAS No. 34 certainly deserves equal individual treatment.

It appears that the Board will continue to compound the problems of SFAS No. 34 with other pronouncements related to the capitalization of interest (SFAS Nos. 58 and 62) unless some rather logical objections are raised. Perhaps it is not too late for the Board to reconsider Statement No. 34 as it has done in the past when it became apparent that such deliberations were necessary.

Earlier this year, Professor Ramsay (*The Woman CPA*, April, pp. 3-7) titled his article "Capitalizing Interest Costs: A Closer Look." After a thorough reading of that article and related accounting literature, it is difficult to comprehend why he sincerely maintains that support for Statement No. 34 by the accounting profession is proper. Many of his observations show that he in fact does grasp, but to a lesser degree, the extent and significance of the conceptual problems that are associated with SFAS No. 34 and the pragmatic problems that it actually instigates. The approach in this article is to take "an even closer look" at SFAS No. 34 in terms of Professor Ramsay's article, and in several instances highlight some of the points we perceive as rather serious problems.

It is believed that many business people and academicians will agree that a prompt reconsideration of SFAS No. 34 is in order. The problems discerned in many cases will be made evident by asking some rather provocative questions about the logic and theory supporting the capitalization of interest.

Rising Interest Rates: A "Material" Concern

The relatively rapid and continuous rise in interest rates during the past decade was given as a justification for the capitalization of interest as an element of the acquisition cost for selected assets. Prior to this trend, the rationale was that noncapitalization with lower rates "led to a conservative income measurement and often was not a material element in income determination" (Ramsay, p. 3).

Given this manner of using materiality as a justification for including interest as a cost of acquisition, would logic dictate that if interest rates began a significant decline that noncapitalization of interest would again be most appropriate? Perhaps some form of the lower-of-or-market method might be designed with some benchmark rate specified as the "cost rate" to regulate when to capitalize. An alternative to this not so unrealistic bit of sarcasm is presented later in our discussion.

The Historical Cost Principle as Basis for Capitalization

The second and certainly more logically sounding justification presented for the capitalization of interest is the applicability of the "cost principle." Upon closer scrutiny, this justification has more holes than (and the aroma of) a fisherman's net.

For an expenditure to be capitalized, two tests have been historically common throughout the accounting literature (e.g. Paton and Littleton, 1940; APB Statement No. 4, 1970):

1. cost must be bona fide and

2. the asset must have future benefits.

The first point requires the item in question be a true and genuine cost (economic sacrifice) that was actually incurred and was reasonable and necessary for the acquisition of the asset. The latter test requires the enhancement of the economic usefulness or value of the resource as a result of the cost incurrence.

An elaboration on the first point as an entirely separate and extensive topic concerning interest as being an opportunity cost, an avoidable cost, and only one element of the economic cost of capital in total of the firm is beyond the scope and space limitations possible in a single journal article. Some brief references, however, must be made to this point in our overall discussion.

There has been sufficient discussion and development in the literature to consider the latter point to a reasonable conclusion. Presumably the reader accepts the

Conceptual Framework Project as a legitimate basis for the development of generally accepted accounting principles. If so, the "future benefits" test that allows interest to be capitalized as an asset would require that the outlay must "contribute directly or indirectly to future net cash inflows" (SFAC No. 3, 1980, p. 9). If this potential cannot be demonstrated, interest should be rejected as a cost of asset acquisition.

As discussed by Professor Ramsay (p. 6), the Board had three alternatives to consider. The result was obviously a compromise standard that was passed by a vote of 4 to 3 with FASB Chairman Kirk casting a dissenting vote.

As Hendriksen (1982), who even appears to be somewhat supportive of SFAS No. 34, stated the case:

> There is little justification for adding interest in one case and not in the other (meaning the comprehensive capitalization of a normalized cost on all funds used). It is difficult to argue that a building is more valuable simply because it was constructed with borrowed funds rather than funds acquired by the sale of stock (pp. 350-351).

His discussion is logically extended to a point Professor Ramsay mentioned in his article. Hendriksen continued:

> Furthermore, since funds are generally commingled, there is no way of determining what proportion of the asset is financed by debt equity and what proportion by stockholder's equity, except in a new firm (p. 351).

Persons with exposure to industrial accounting at the corporate level no doubt understand why senior financial officers and cash managers of large integrated entities would agree with this rational and quite practical statement. In fact, one outspoken comptroller of a major U.S. corporation stated that the "GAAP" between accounting and economic reality is widening (D.R. Borst, TWIR, July 23, 1982). His suggestions included the abolition of deferred tax accounting, the non-capitalization of leases, and charging interest to expense as a period cost. Overall, he merely advocated a return to the simple economic reality of events as viewed by management in their decision-making processes.

Interest Capitalization and The Conceptual Framework Project

If the Conceptual Framework Project is accepted as the basis for the development of accounting standards, the question arises if the capitalization of interest improves the qualitative content of accounting information. Pointedly, does the inclusion of interest in the cost of an asset provide the users of financial information with improved decision-making usefulness? Does it provide the user with more "relevant" information for decision-making purposes?

The Board defined this qualitative characteristic of accounting information as one giving such information "predictive value." This characteristic means: "Specifically, it is information's capacity to 'make a difference' that identifies it as relevant to a decision" (SFAC No. 2, 1980, p. 21). The all-important phrase "make a difference" may have several valid interpretations, and one of these interpretations is a key part of the Conceptual Framework Project. Stated as a question: Do the requirements of SFAS No. 34 assist the decision-maker "in assessing the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (SFAC No. 1, 1978, pp. 17-18)? Or do they, as Professor Ramsay notes, provide management with the potential "for manipulation of reported earnings" (p. 4)?

The Board stated that: "The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components" (SFAC No. 1, 1978, p. 21). Given this primary focus, does an accounting standard that allows for "potential manipulation of reported earnings" lend credibility to the qualitative characteristic of "representational faithfulness" as discussed in SFAC No. 2 for such information to be reliable?

These points have been made to show that the requirements of SFAS No. 34 fail to provide users with improved information that is either relevant or reliable (potentially lacking representational faithfulness and freedom from preparer bias) as well as failing to meet one of

Does inclusion of interest costs "make a difference" in the predictive values of financial statements?

the primary objectives of financial reporting.

In short, SFAS No. 34 lacks consistency with the Conceptual Framework Project and sound accounting logic. It is a compromise standard with little theoretical justification. This is the type of position that cannot be maintained for any period of time without numerous amendments, interpretations, and eventually supercession (e.g. SFAS Nos. 8 and 13 and quite likely No. 33).

Accordingly, the Board should review this Standard and either return to the treatment of interest as a financial cost of the period in which it is incurred or accept that all funds, regardless of their source, have an economic cost and capitalize these as a portion of the assets' cost. If there is to be a form of capitalization, the authors prefer an attempt at a direct cause and effect association. This may be accomplished by tracing funding approvals from the Board of Directors as reported in their respective minutes to the segregation of the funding proceeds to the approved projects. All other charges would be treated as period costs instead of being tossed into a general interest pool awaiting an arbitrary allocation approach to be applied. If an all-inclusive capitalization is chosen, the Board may consider using the weighted average cost of capital (all funds) as a basis for determining the total amount of cost to be capitalized.

Several Observations About 'A Closer Look' at the Capitalization of Interest

Several other points gleaned from the article (Ramsay, 1982) show that a closer look at interest capitalization is needed. It was stated that the Internal Revenue Code allows the taxpayer to either capitalize interest as an asset cost or deduct it as an expense. With the latter treatment being chosen more often, "the resulting economics of SFAS No. 34 have a negligible effect upon cash flow but a noticeable impact on reported financial information" (Ramsay, 1982, p. 4).

Is this desirable and consistent with the objectives of financial reporting for potential users attempting to determine the timing, amount, and uncertainty of cash flows? Does this enhance the primary qualitative characteristic of providing "relevant" information if the potential impact on reported earnings is significant but the impact on cash flows is negligible? (Do these questions sound somewhat familiar?)

The answer seems to be a resounding "NO" in each case. The effect of SFAS No. 34 is to widen the difference between reported earnings and income tax accounting and distort the Deferred Income Tax account even more when compounded with the effects of the Economic Recovery Tax Act of 1981. These combined points make income tax allocation and the deferred income tax account even less useful for users of financial statements who are attempting to predict future cash flows.

Another observation is "an abuse" by management described as the "increased opportunities for manipulation of reported earnings" (Ramsay, p. 5) by altering the manner of funding expansion programs. How can the application of promulgated generally accepted accounting principles (GAAP) be called an "abuse?" If management chooses to fund a project by debt rather than equity or internal retention of funds (indirect equity), and thus have a favorable effect on reported earnings, how can anyone label this an abuse? It is simply good financial management—not to mention being mandated by the Board. Obviously the Board, via SFAS No. 34, is the cause of the "potential abuse."

The Board has simply opted for an alternative to pacify two extremes and has created the opportunity for potential abuse in several different manners as discussed by Ramsay. To pursue this thought further, consider what may happen when interest rates decline, as they have done recently, to a point where the capitalization of interest costs is no longer deemed material by some entities, and yet material by others. It will be more interesting to observe interfirm comparability of earnings, ratio and cash flow analysis become quite distorted—and all in the name of GAAP via SFAS No. 34. Perhaps this will be the point where the Board will introduce a benchmark interest rate (materiality quantified by the piecemeal approach, e.g. APB Opinion 15 — 3% dilution test) to determine when capitalization is appropriate. This will certainly assist in the establishment of interest as a bona fide cost to be included as an asset.

The final point that merits some discussion is contained in the conclusion of the article. "The Board has applied cost/benefit considerations . . . for better reflecting the economic reality of business enterprises" (Ramsay, p. 7). The Committee on Concepts and Standards for External Financial Reports (*Statement on Accounting Theory and Theory Acceptance*, 1977) made the observation quite clearly that the "cost-benefit" test in many circumstances, when used as the basis for the development of accounting theory, was of an abstract nature and not capable of proof by quantification. Therefore, one must ask if the Board used differential cost and benefit tests of this information required in SFAS No. 34 on an entity basis, aggregative basis or from a decision-making model used by investors and creditors? As mentioned by the Committee (1977), if authoritative boards and writers were taken to task more often when using the "cost-benefit" phrase as a justification for theory, most would simply admit to administrative dictum or compromise as the true basis for an accounting standard.

Conclusion

The questions raised herein merit an early and closer look at the conceptual arguments given as a basis for the capitalization of interest as an acquisition cost of selected assets. Consideration should also be given to some of the pragmatic difficulties associated with SFAS No. 34 as mentioned by Ramsay (1982). There is little justification for continuing with a temporary compromise standard when many astute observers can see the problems involved with this Statement. A reconsideration is needed to develop a more logical and lasting standard in the area of interest capitalization. Ω

REFERENCES

American Accounting Association (1977). Committee on Concepts and Standards for External Financial Reports. "Statement on Accounting Theory and Theory Acceptance." American Accounting Association, 1977, pp. 36, 37, 51, and 52.

American Institute of Certified Public Accountants (1970). Accounting Principles Board. *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*. Statement No. 4 of the Accounting Principles Board, 1970.

Borst, Dewey R. (1982). "Accounting Vs. Reality: How Wide is the 'GAAP'?" Deloitte, Haskins and Sells (TWIR), July 23, 1982.

Ernst and Whinney (1981). *The Economic Recovery Tax Act of 1981*. "Capital Cost Recovery."

Financial Accounting Standards Board (1978). "Objectives of Financial Reporting by Business Enterprises." Statement of Financial Accounting Concepts No. 1.

Financial Accounting Standards Board (1979). "Financial Reporting and Changing Prices." Statement of Financial Accounting Standards No. 33.

Financial Accounting Standards Board (1979). "Capitalization of Interest Costs." Statement of Financial Accounting Standards No. 34.

Financial Accounting Standards Board (1980). "Qualitative Characteristics of Accounting Information." Statement of Financial Accounting Concepts No. 2.

Financial Accounting Standards Board (1980). "Elements of Financial Statements of Business Enterprises." Statement of Financial Accounting Concepts No. 3.

Financial Accounting Standards Board (1982). "Capitalization of Interest Cost in Financial Statements that Include Investments Accounted for by the Equity Method (An amendment of FASB Statement No. 34)." Statement of Financial Accounting Standards No. 58.

Financial Accounting Standards Board (1982). "Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants." Statement of Financial Accounting Standards No. 62.

Hendriksen, Elden S. (1982). *Accounting Theory*, 4th ed. Homewood, Illinois: Richard D. Irwin, Inc.

Paton, W.A., and A.C. Littleton (1940). *An Introduction to Corporate Accounting Standards*. Monograph No. 3. American Accounting Association, 1940.

Ramsay, Louis P. (1982). "Capitalizing Interest Costs: A Closer Look." The Woman CPA (April, 1982) pp. 3-7.

Donna A. Dingus, *CPA, holds a Master of Accounting degree from Ohio State University. She is a former instructor of accounting at Marshall University, and is a member of the Ohio Society of CPAs, AICPA, and American Woman's Society of CPAs. She has served on the editorial staff of The Ohio CPA, and is currently a member of the Editorial Board of The Woman CPA.*

Roland L. Madison, *CPA, Ph.D., is associate professor of accounting at Marshall University. He holds memberships in the West Virginia Society of CPAs, AICPA, NAA, AAA, the Ohio Valley Accountants Association, and the American Woman's Society of CPAs. He has published widely in professional accounting and business journals, and is a previous contributor to The Woman CPA.*

American Society of Women Accountants

President
Jo Ann C. Dooley
Gardner Publications, Inc.
6600 Clough Pike
Cincinnati, OH 45244

President-Elect
Lee G. Smart
Union Planters National Bank of Memphis
P.O. Box 387
Memphis, TN 38147

Vice Presidents
Barbara H. Brock
135 Meadow Road
Buffalo, NY 14216
(Technical Projects)

Jean E. Krieger
3963 Fairlington Dr.
Columbus, OH 43220
(Research & Development)

Gail E. Schiffer
Winick, Schiffer & Hirmes
570 Seventh Ave., Ste. 1203
New York, NY 10018
(Administration)

Secretary
Cecilia C. Monahan
1019 Academy Ave.
Cincinnati, OH 45205

Treasurer
Arlene A. Clement
71 Fairview Drive
Wethersfield, CT 06109

Directors
Marilyn B. Dreyer
Touche Ross & Co.
600 "B" Street, Ste. 1000
San Diego, CA 92101
(Bylaws)

Vickie L. Fisher
Fox & Company, CPAs
P.O. Box 25683
Albuquerque, NM 87125
(Student Activities)

Linda S. Fowler
6227 South Pinesap
Houston, TX 77072
(Bulletin)

E. Vicki Heberling
301 116th Ave., Ste. 520
Bellevue, WA 98004
(Education & Legislation)

Idelle S. Hirsch
1284 Moncoeur Drive
Creve Coeur, MO 63141
(Public Relations)

Gladys Hyatt
2220 West Birch
Bellingham, WA 98226
(Program)

Donna M. Johnson
19209 Auburndale
Livonia, MI 48152
(Publicity)

Mary J. O'Conner
6981 Laser Drive
Anchorage, AK 99504
(Awards)

Maureen C. Schreiber
726 Bayou Liberty Road
Slidell, LA
(Chapter Development)

Karen R. Spencer
5504-11th Ave., S.
Birmingham, AL
(Member Relations)

Christine M. Summers
Continental Illinois National Bank
and Trust Company
231 South LaSalle St.
Chicago, IL 60693
(Membership)

Immediate Past President
Helen M. Shepherd
Touche Ross & Co.
3700 Wilshire Blvd.
Los Angeles, CA 90010
(Policy & Procedures)

National Headquarters
Suite 1036
35 East Wacker Drive
Chicago, IL 60601

The Educational Foundation of AWSCPA-ASWA

President
Yvonne O. Braune, CPA

President-Elect
Vickie Stallings, CPA

Vice Presidents
Virginia Bigio, CPA
Helen M. Smith

Secretary
Ann M. Dusin, CPA

Treasurer
Marjorie Knesel

Trustees
Margaret A. Cartier, CPA
Arlene Clement, CPA
Larzette Hale, CPA
Florence L. Haggis, CPA
Helen F. McGillicuddy, CPA
Bess V. McMannama
Elizabeth Reid
Phyllis N. T. Shea, CPA
Varley M. Simons, CPA
Barbara Solan
Margo Stephens
Nancy A. Weinstein

National Headquarters
P.O. Box 389
Marysville, OH 43040

American Woman's Society Of Certified Public Accountants

President
Shirley J. Dahl, CPA
Price Waterhouse
606 South Olive Street
Los Angeles, CA 90014

President-Elect
Kathryn C. Buckner, CPA
Route 1, Box 60
Ono Road
Palmetto, GA 30268

Vice Presidents
Judith H. Byrum, CPA
5950 Roe
Mission, KA 66205

Mable Kitchen, CPA
2429 Crane Schoolhouse Road
Bethel, OH 45106

Glenda E. Ried, CPA
College of Bus. Adm.
University of Toledo
2801 W. Bancroft
Toledo, OH 43606

Secretary
Carol H. Martensen, CPA
Geer, Martensen, Jansen &
Kennedy, PC
5343 E. Pima
Tucson, AZ 85712

Treasurer
Glenda M. Bayless, CPA
720 Bloomington Ave.
Bloomington, CA 92316

Directors
Elizabeth O. Acosta, CPA
27520 Hawthorne Blvd.
Suite 177
Rolling Hills Estate, CA 90274

Margaret Cartier, CPA
Altschuler, Melvoin and
Glasser
69 W. Washington St.
Chicago, IL 60602

Theresa M. Cologie, CPA
15 McKenzie Ave.
East Rutherford, NJ 07073

Karen L. Hooks, CPA
University of South Florida
College of Business
Tampa, FL 33620
(Accounting Standards
Coordinating Committee)

Linda L. Jardine, CPA
Main Hurdman
1050 17th St., N.W.
Washington, DC 20036
(Seminar Presentation)

Elizabeth Pozzi, CPA
9112 Wilcrest
Houston, TX 77099

Margaret Worthington, CPA
Price Waterhouse
1801 K Street, N.W.
Washington, DC 20006
(Newsletter)

Immediate Past President
Carla A. Russell, CPA
2308 Avalon Place
Houston, TX 77019

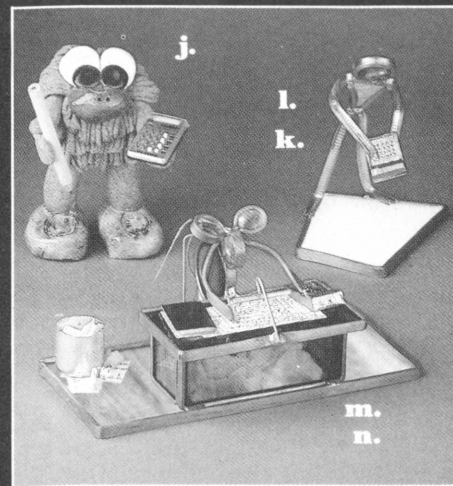
Administrative Office
500 North Michigan
Suite 1400
Chicago, IL 60611

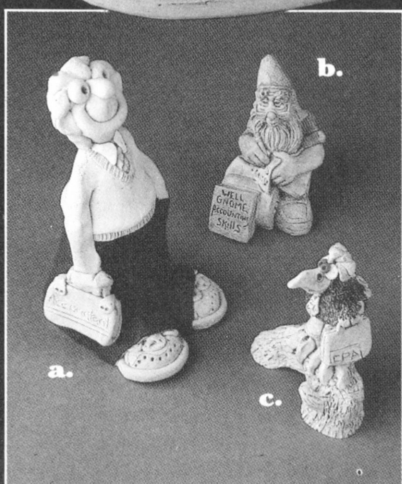
THE PROFESSIONALS

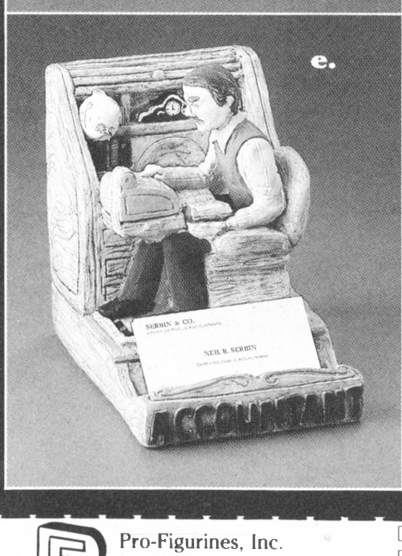
An exclusive selection of collectibles honoring the accounting profession.

For the office...home...for special gifts, mementos or presentations, Pro-Figurines markets this exclusive selection of collectibles. Each figurine is unique and fills that special niche for the beginning or continuing collection. These figures add a warm touch to personalize the working environment.

Order for yourself or a valued associate. Here's a special way to honor CPA's, accountants, bookkeepers, comptrollers and other professionals...by Pro-Figurines.







A trio of whimsical characters in ferro-oxide castings, each hand-painted and hand finished. Detailed to produce a loveable personality.

a. He's the **"Happy Accountant"** by B. J. Birdfeather. Stands 6¾" tall with "Accountant" briefcase. Ready to adorn your office. **20.00**

b. The grinning merlin of credits and debits, the **"Well Gnome Accountant."** He'll share his magic with you. 3¾" tall. **17.50**

c. Perched on a branch, the **"Herd of Birds CPA"** by B. J. Birdfeather has a "nose for figures," numeral-patterned tie, and CPA briefcase. 4¼" tall. **12.50**

d. From the Kaplan Studio of California comes **"The Accountant,"** a serious study of art in a fine densite casting. Hand-painted, every meticulous detail from the roll-top desk to his hat and coat has been individually hand-crafted. Hand-signed and numbered in an edition limited to 750 pieces for those special few. The Certificate of Authenticity is enclosed in a leatherette booklet. 7 x 7¼ x 7½" tall. **210.00**

e. The **"Accountant Card Holder"** by Lauren Marems Studio of California is a magnificent collectible by a most versatile artist. Cleverly detailed with knick-knacks, desk accessories...even a tape in the adder, this hand-crafted densite casting has been carefully decorated with magnificent detailing. Holds business cards or a nameplate. 4½ x 6¼ x 6½" tall. **70.00**

f. Limited to a surprisingly small edition of 500 is the **"Accountant at Work"** by the Marems Studio. The artist's skill is exemplified by the hand-painted Victorian lamp, time on the clock, pencil behind his ear, desk accessories, and pigeon-holed papers. Artist signed and numbered, this hand-crafted densite casting is a treasure to own. 8¼ x 8½ x 9" tall. **135.00**

The Whittle Works Accountants Grouping is a nostalgic collection of original wood-carving reproductions with hand-painted detail. No two pieces are alike—each figurine is unique.

g. "How To Be An Accountant," bearded and bespectacled, sitting on books. 4½" tall. **32.50**

h. "How To Keep The IRS Happy" is a business card holder. 4 x 5½ x 5½" tall. **45.00**

i. "The Accounting Office" shows a busy twosome in their office with decorative embellishments and stack of paperwork. 7¼ x 6 x 4¾" tall. **45.00**

j. Aw, it's cute! It's the **"Harries® Accountant,"** a bit of whimsy in glazed and unglazed pottery clay. 4" tall. **19.00**

A unique art form combining the wit of cartooning with the beauty of leaded stained glass. Totally handcrafted—no two alike. "Glass Cartoons" are available in either an office scene or as a free-standing professional.

k. "Human Cartoon Accountant." 4¼" tall. **21.00**

l. "Mouse Cartoon Accountant." 2¾" tall. **21.00**

m. "Human Cartoon Accounting Office." 7 x 3 x 3¼" tall. **40.00**

n. "Mouse Cartoon Accounting Office." 7 x 3 x 3¼" tall. **40.00**

All dimensions are approximate over-all sizes.

ALL PRICES INCLUDE SHIPPING AND INSURANCE!

Pro-Figurines, Inc.
1750 W. Summit Ct.
Deerfield, IL 60015

Please send me:

Qty.	Description	Each	Total

☐ Check Enclosed ☐ American Express
☐ Master Card ☐ Visa NO COD'S.

Card Number ____________
Exp. Date ____________

Name ____________
Street Address ____________
City ____________ State ______ Zip ______
Signature ____________ Date ______

For deliveries in Illinois, please add 7% sales tax.

Order With Confidence! Your satisfaction is guaranteed, or you may return your purchase (in the original shipping container) within 30 days after receipt for a full refund. Please allow 30 days for UPS delivery. Additional shipping charge for deliveries outside U.S.A. Be sure to include your street address. For delivery in Illinois, please add 7% sales tax.

For Fastest Delivery on Credit Card orders

(Visa, Master Card and American Express)

CALL COLLECT
(312) 940-0040

SEC ACCOUNTING FELLOW PROGRAM ENTERS ITS ELEVENTH YEAR

The Securities and Exchange Commission is now accepting applications (until December 31) for its highly successful Professional Accounting Fellow program. Two individuals will be selected in early 1983 for two-year terms to begin in the early summer.

Applicants are required to submit background information and a brief position paper on an accounting subject of interest to them and germane to the SEC. An announcement describing the program and application procedures is available from the Office of the Chief Accountant, SEC, 450 Fifth Street, N.W., Washington, D.C. 20549.

According to Clarence Sampson, Chief Accountant, the fellowship candidate should have one or more years' of managerial experience in a public accounting firm, or in an organization which provides equivalent experience. In addition, the applicant should be thoroughly familiar with the technical accounting and auditing literature as well as current accounting issues confronting the profession.

Work assignments typically include the study of significant accounting, auditing and disclosure issues or concepts, participation in the drafting of financial reporting releases and staff accounting bulletins, evaluation of current reporting by registrants, interaction with various governmental and private professional accounting groups and presentations at accounting conferences and meetings.

The program provides an outstanding opportunity for personal development and career enhancement. An SEC Fellow deals with a broad range of issues that develop problem-solving abilities and that provide the individual with invaluable exposure to the regulatory and standard-setting environment. To date, fifteen alumni of this program have returned to the public accounting profession. The success of the program is reflected in the continuing benefits to the profession as well as to the former Fellows from the experience gained while working at the SEC.

Audit Sampling

A Simplified Updated View

By Russell F. Briner

The process of audit sampling probably dates back to the Industrial Revolution. Corporate transactions became so numerous during and after that era that it became impossible for the auditors to examine every transaction in auditing the assertions of financial statements. Interestingly enough, however, there have been very few guidelines set forth in auditing authoritative pronouncements over the years related specifically to audit sampling. In June of 1981, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Standards (SAS) No. 39 entitled "Audit Sampling."

The purpose of this article is to highlight the significant elements of SAS No. 39 and to provide insight as to the effects of this pronouncement upon the auditing process. In today's business environment the independent auditor, the internal auditor and the management accountant are three important participants in the financial statement auditing process. Knowledge of authoritative guidelines on audit sampling by all three parties should assist in increasing audit efficiency and lessening audit costs.

Audit Sampling Prior to SAS No. 39

The justifiable basis of audit sampling arises directly from the auditor's (CPA's) standard short-form audit report as promulgated by the AICPA. The first paragraph of that audit report states in part that "Our examination . . . included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances." The second paragraph of the audit report then expresses an "opinion" on the fairness of the financial statements. The implication from reading the report should be clear that not *all* accounting records were examined by the auditor but only a portion or "sample" of the accounting records were examined.

Further justification for application of tests and use of samples is found in the third standard of field work of the Generally Accepted Auditing Standards (GAAS) of the AICPA. The third standard requires "sufficient competent evidential matter" to be collected by the auditor to "afford a reasonable basis for an opinion regarding the financial statements under examination." Reasonableness, of course, does not mean absolute certainty and audit samples are the means of gathering evidence to afford reasonableness.

The second standard of field work concerns a study and evaluation of internal control and the interpretation of this standard by the SAS's is also related to audit sampling. In order to evaluate internal control, there must be some assurance, but not a complete certainty, that the internal control system is operating as intended. Therefore, pertinent control procedures should be tested as to their effectiveness through tests of samples of documentary data and by observation. These tests are called tests of compliance.

The most often used method for selecting samples of transactions over the years has been judgment sampling. In this method the size and composition of each audit sample is predetermined by the auditor based on the experience and knowledge of the auditor. This method has the obvious disadvantage of leaving a great uncertainty concerning the risk absorbed by the auditor. With this uncertainty or risk in mind, auditors developed statistical audit sampling which measured risk taken but did not eliminate judgments in applying the approach.

Authoritative literature in auditing was lacking as related to either judgment or statistical sampling until 1972. The only references in the literature prior to 1972 which related to audit sampling were those previously mentioned concerning the second and third standards of field work of GAAS and interpretations thereof. Most of those references evolved in the 1930's and 1940's.

In 1972 the Committee on Auditing Procedure of the AICPA (predecessor to the ASB) adopted two statements which were incorporated as appendixes to SAS No. 1, Sec. 320. These appendixes provided guidance for the use of statistical sampling by the auditor. The most significant aspects of these appendixes (SAS No. 1, Sections 320A and 320B) were: (1) authoritative approval of statistical sampling but notation that use of judgment is not

The auditor's risk derives from not examining every transaction or piece of data.

reduced by this sampling approach; (2) discussion of the statistical term of "precision" and "reliability"; and (3) discussion of audit factors involved in applying statistical sampling and setting precision and reliability levels as related to compliance tests and substantive tests (direct tests of account balances). As noted in the second appendix (SAS No. 1, Sec. 320B): "This Appendix does not discuss any of the statistical theory or techniques required to execute a valid statistical sample ..." The discussion linked materiality to precision and reasonableness desired to reliability levels and discussed the effects on audit risk of various levels of precision and reliability."

Until 1981, then, specific guidance in the authoritative auditing literature as to the appropriate procedures for audit sampling was sparse. This situation was changed with the issuance in June 1981 of SAS No. 39, "Auditing Sampling."

The Updated View — SAS No. 39

SAS No. 39 provides guidance for planning, performing and evaluating audit samples. The end result of this statement most likely will be a more structured approach to audit sampling, both judgmental and statistical. The statement itself approves both of the above named sampling approaches but uses the term "nonstatistical sampling" to replace judgmental sampling. The structure specified for the auditor's sampling approach is significant because the following of the statement's guidelines should eliminate some of the variations that have existed between auditors in sampling and provide documentation of their work in complying with the statement guidelines.

Figure 1 outlines the general content of SAS No. 39 and the following paragraphs discuss the significance of this content to the parties involved in the auditing process.

Sampling and Nonsampling Risk

The auditor's risk derives from not examining every transaction or piece of data which underly the financial statements. One way to view this risk is to divide the risk into sampling risk and nonsampling risk. The first risk, sampling risk, is the uncertainty that the results of an audit sample will not be representative of the population as a whole thus leading to an erroneous conclusion about the population. The items composing an account balance and the evaluation of a sample thereof is an example of risk involvement from an auditor's standpoint. Nonsampling risk represents uncertainty involved in the auditing process other than from sampling. An error made by the auditor in performing audit procedures and not discovered upon review is an example of nonsampling risk. SAS No. 39 is primarily concerned with sampling risk and discusses two aspects of this risk for tests of compliance of internal control and for direct tests of account balances.

Many auditors and accountants associated in some way with the auditing process may become uneasy when new or unfamiliar technical terms are used related to a process with which they are knowledgeable to varying degrees. This uneasiness, if occurring when reading SAS No. 39, should not be evidenced after considering closely and in a not so technical way the contents of SAS No. 39. Most of the terminology used in SAS No. 39 incorporates the basic philosophy financial auditing has used since its inception. Some unfamiliar terms may be introduced but these terms are basically related to aspects of auditing which have not changed much over many years. Such is the case when considering the two following aspects of sampling risk for direct tests of account balances as specified by SAS No. 39: (1) the risk of incorrect acceptance and (2) the risk of incorrect rejection. Although these terms are new, the basic underlying concepts involved are not new.

Financial statements consist of many account balances and in taking samples of these balances the auditor faces uncertainity as to whether the balances are fairly stated. The auditor attempts to gather evidence to support fair presentation of the balances but doubt will always remain as to fairness. This doubt represents risk in the auditing process. The auditor may gather enough evidence to support fair presentation, but, in fact, the balance of an account may be materially misstated. The risk that the preceding will happen is called the risk of incorrect acceptance by SAS No. 39. On the other hand, the auditor may gather evidence which indicates (through sampling) that the account balance is materially misstated when, in fact, the balance is fairly stated. The auditor, of course, does not know that the incorrect conclusion has been made. The risk of rejecting the account balance as not fairly stated when, in fact, the balance is fairly stated is called the risk of incorrect rejection by SAS No. 39. In statistical sampling the risk of incorrect acceptance is referred to as the Type II or beta risk while the risk of incorrect rejection is known as the Type I or aplha risk. SAS No. 39 applies to both statistical and nonstatistical sampling and the application of the two types of sampling risk does not require statistical expertise when viewed in connection with SAS No. 39.*

In testing internal control, the two types of sampling risks again may be applied but in slightly different terminology. The risk of overreliance on internal control is noted by SAS No. 39 as "the risk that the sample supports the auditor's planned degree of reliance on the control when the true compliance rate does not justify such reliance." The risk of underreliance occurs when evi-

*Much of the discussion of audit risk, precision and reliability in these appendixes is common with the treatment of these concepts in SAS No. 39 and thus further discussion is deferred to a subsequent section.

*The statement does suggest that the risks may be quantified (usually in percentage terms) but such a quantification depends upon auditor judgment.

FIGURE 1

An Outline of SAS No. 39*
"Audit Sampling"

I. Purpose — To provide guidance for planning, performing and evaluating audit samples.

II. Uncertainty in audit sampling — Consists of two types of sampling risks in relation to direct tests of details of account balances or tests of compliance of internal control procedures.
- A. Direct tests of account balances
  - 1. Risk of incorrect acceptance
  - 2. Risk of incorrect rejection
- B. Tests of compliance of internal control
  - 1. Risk of overreliance
  - 2. Risk of underreliance

III. Planning audit samples
- A. Considerations for direct tests of account balances
  - 1. Audit objective of test
  - 2. Materiality level allowable
  - 3. Allowable risk of incorrect acceptance
  - 4. Characteristics of population
- B. Considerations for tests of compliance of internal control procedures
  - 1. Audit objective of test
  - 2. Maximum rate of deviations allowed
  - 3. Allowable risk of overreliance
  - 4. Characteristics of the population
- C. Sample size — determined after assessing the planning considerations

IV. Selecting audit samples — Use of a selection methods that affords all items in population the chance of selection.

V. Performance and evaluation of audit samples.
- A. Project error or deviation results of sample to entire population for assessment.
- B. Consider qualitative aspects of errors or deviations in sample results.

VI. Effective Date — Effective for examinations of financial statements on or after June 25, 1982.

* Auditing Standards Board of American Institute of Certified Public Accountants, *Statement on Auditing Standards No. 39,* "Auditing Sampling" (June 1981).

dence from a sample does not support the auditor's planned reliance on internal control but, in fact, the procedure(s) being tested does have a compliance rate which supports such reliance.

Rejection of an account balance as being materially misstated and evidence of unreliable internal control ordinarily result in additional audit procedures that are performed until doubts (risks) in these area are satisfied. The greatest effect on the auditing process related to this type of risk (risk of incorrect rejection or risk of underreliance) is additional audit time and cost to reduce the risk. The other type of risk (risk of incorrect acceptance or risk of overreliance) is the prime danger in auditing and this risk should be considered very carefully in planning, selecting and evaluating audit samples. The suggestions of SAS No. 39 concerning the consideration of this type of risk are explained in the next section.

Planning Audit Samples

In terms of planning the audit samples there are certain guidelines suggested by SAS No. 39 which the independent auditor must follow. The internal auditor, on the other hand, may be able to assist the independent auditor in a most efficient manner by being knowledgeable of these guidelines. The management or corporate accountant may also add to the efficiency of the independent audit by being aware of the factors involved in planning audit samples. Such awareness by the corporate accountant, for example, would enable the structuring of data files so samples could easily be drawn or providing a visible documentation trail which could easily be sampled. The same reasoning used for knowledge needed for planning audit samples may also be applied to selecting audit samples and performing and evaluation audit samples which are discussed in the sections following this one.

Undoubtedly the best sample results will come from a well planned sample. For direct tests of details of account balances, SAS No. 39 suggests the following considerations:

(1) The relationship of the sample to the relevant audit objective.

Although statistical terms are new, the basic underlying concepts involved are not new.

(2) Preliminary estimates of materiality levels.

(3) The auditor's allowable risk of incorrect acceptance.

(4) Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

In reference to the first consideration suggested by SAS No. 39 in planning audit samples for direct tests, the primary audit objective is to test the fairness of the account balance. The population to be tested should be clearly identified. As noted by SAS No. 39 this population which *should* make up the account balance may include items which are not presently included in the balance. For instance, the omission of recording a sale on account would result in a missing amount from both the accounts receivable and sales account balances. In testing the accounts, the auditor should include a consideration of sampling shipping documents to plan for the discovery of unrecorded sales.

The second consideration in planning for direct tests is related in estimates of materiality levels. The auditor must specify in monetary terms, according to SAS No. 39, the maximum amount of error for an account balance to be tested which could exist without causing a material misstatement of the financial statements. The maximum amount of monetary error is named the *tolerable error* by SAS No. 39. If accounts receivable had a balance of $100,000, the auditor might be willing to accept an error, based on sampling results, of up to $10,000 wihout modifying the auditor's judgment that the balance was not fairly stated. The $10,000 then becomes the tolerable error. Note that a sample may have a much smaller error than $10,000 but when this smaller error is projected to the population as a whole, the projected error may or may not be greater than $10,000. Using the preceding example, assume a sample of the accounts receivable balance representing approximately one-fifth of the account balance results in a $1,500 total error between book values and audited values with book value being overstated. When projected to the entire balance on a proportionate basis ($1,500 divided by one-fifth), the error overstatement would be $7,500. This error is less than the tolerable error of $10,000 and if corroborating evidence was supportive, the account balance could be accepted as fairly stated.*

The risk of incorrect acceptance has been previously explained and also noted as a prime consideration in planning audit samples. In considering this risk, the auditor considers the reliance to be placed on internal control, the other auditing procedures performed, the relative risk as related to the environmental factors and materiality of account balance as related to the financial statements as a whole. Strong internal control, numerous additional audit procedures or a relatively small account balance may enable the auditor to absorb a relatively large risk of incorrect acceptance in a particular audit sample. The interactive stengths or weaknesses of the preceding factors will affect the level of risk. Also the audit consists of many samples so the risk of incorrect acceptance may vary from sample to sample. SAS No. 39 does not require the risk to be quantified in percentage terms, but in order to comply with the statement it would appear that documentation of the considerations of the risk of incorrect acceptance would be necessary.

The items composing an account balance should be considered carefully in planning audit samples. Some items may be larger in dollar value than others. Some items may be of greater relative importance or risk than others, e.g., a receivable from a related party or a receivable from a stockholder. Thus the items of larger values or relative importance should be given greater consideration for inclusion in sample.

The considerations for planning an audit sample for a compliance test of an internal control procedure as specified by SAS No. 39 are:

(1) The relationship of the sample to the objective of the compliance test.

(2) The maximum rate of deviations from prescribed control procedures that would support planned reliance.

(3) The auditor's allowable risk of overreliance.

(4) Characteristics of the population, that is, the items comprising the account balance or class of transactions of interest.

In reviewing the considerations in planning for audit samples of tests of compliance, the primary objective of a compliance test is to test the extent that an internal control procedure is operating as such a procedure was so intended to operate. The auditor should have some familiarity with the expected rate of deviations from the procedure (usually stated in terms of a percentage rate deviation) and should select the maximum rate of deviation that the auditor would accept and still rely on the selected control procedure. This maximum rate is entitled by SAS No. 39 as the *tolerable rate*. The higher the tolerable rate the smaller sample needed and vice-versa. The allowable risk of overreliance must be planned also. Normally in internal control tests, this risk should be kept low because of the subsequent reliance on internal control as basis for reducing the extent of tests of account balances. A typical example might consist of testing the verification of extension prices on a sales invoice. The control procedure is the extending and footing of invoice by a second person and then initialing such verification. The deviation is an incorrect but undetected verification by the second individual. The auditor should know the number of sales invoices for a period (the population),

*The account receivable example illustrated here *is not* used in SAS No. 39 nor are any other numerical illustrations as used in this article from SAS No. 39. Also the statement (SAS No. 39) *does not* suggest the proportionate method of projecting sample results as the only method that may be used in projecting sample results.

estimate a deviation rate (e.g., two percent are incorrectly verified) and set an allowable risk of overreliance (e.g., five percent). A sample of invoices is then selected, tested and evaluated by the auditor.

Finally, in determining the size of samples to be taken by the auditor, either for tests of account balances or compliance tests, the considerations previously discussed must be evaluated by the auditor and sample size then determined. For statistical sampling, the considerations are quantified and sample size determined on a formula basis (or through use of appropriate statistical tables). For nonstatistical sampling, a judgment is made in regard to sample size after due consideration of the relevant factors.* Regardless of the approach, the sample size determination process should be well documented.

Sample Selection

For sample selection SAS No. 39 emphasizes that all items in the population should have an opportunity to be selected. This concept applies to samples used in either direct testing of account balances or tests of compliance of internal control procedures. Random-based selection of items is the only selection approach specifically mentioned in SAS No. 39.

Sample Performance and Evaluation

An audit of financial statements involves gathering evidence from audit procedures applied to financial statement items. Audit samples of many kinds of data will be part of the evidence collected but not the entire body evidence supporting the audit opinion. All evidence should be judged in aggregate concerning the financial statements taken as a whole. This includes the evidence gathered from audit samples. Audit samples also consist of only part of the evidence gathered to support fairness of each account balance or major class of transactions considered material. Each audit sample must be evaluated in relation to the account balance or internal control procedure related to an account balance.

SAS No. 39 recommends projecting the sample results to the entire population being tested. In direct tests, the error results would be projected; in compliance tests the deviation rate would be projected. That statement simply notes that there are several acceptable ways to project samples results to entire population but does not recommend any particular approach.

The qualitative aspects of errors or deviations should be evaluated as well as the quantitative effects. SAS No. 39 notes the qualitative aspects of errors in direct tests of account balances are as follows:

(1) The nature and cause of misstatements.

(2) The possible relationships of the misstatements to other phases of the audit.

In reference to (1), an error in the form of an irregularity has greater connotation than an error in the form of an unintentional mistake.

For compliance tests, qualitative aspects of deviations include:

(1) The nature and cause of deviations.

(2) The possible relationship of the deviations to other phases of the audit.

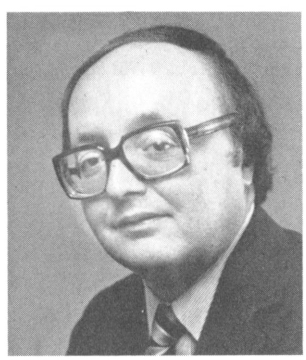
If the sample results for either a direct test or compliance test do not provide evidence which, in the auditor's judgment, support the predetermined materiality level (direct tests) for an account balance or degree of predetermined reliance (compliance test) on internal control, then further audit plans should be altered to compensate for the conflicting results.

Conclusion

For the first time in modern financial auditing history, the authoritative literature of financial auditing contains specific requirements for audit sampling. These requirements are specified in SAS No. 39 entitled "Audit Sampling" issued by the ASB in June 1981.

SAS No. 39 identifies and provides guidelines concerning the audit sampling risks involved in samples used in connection with direct tests of details of account balances and/or major classes of transactions and in tests of compliance of internal accounting control procedures. Guidelines are also provided for planning, selecting and performing and evaluating samples used in the preceding connection.

The statement (SAS No. 39) is a big step in providing a structured approach to audit sampling. The benefits of SAS No. 39 will be realized to their greatest potential only if all parties involved in the auditing process (the auditors and the auditees) are sufficiently familiar with the audit sampling guidelines provided in SAS No. 39. Ω



Russell F. Briner, *CPA, Ph.D., is associate professor and director of graduate studies of the School of Accountancy at the University of Mississippi. He was formerly with the faculty of Sam Houston State University, is a member of AICPA, AAA, NAA, and has published in various accounting journals.*

*In statistical sampling the terms precision and reliability are related to sample size determination. Precision is related to tolerable error and tolerable rate while reliability is the complement of the risk of incorrect rejection and risk of underreliance. Relating precision and reliability to SAS No. 39 should be undertaken only by those sufficiently knowledgeable with statistical sampling as applied to the audit process.

Compilation And Review Reports

Are They Understood?

By Thomas P. Edmonds, Mattie C. Porter, and Ira R. Weiss

With the issuance of the first Statement on Standards for Accounting and Review Services, *Compilation and Review of Financial Statements*[1], the AICPA provided new standards for reporting for the CPA who is associated with the financial statements of a privately held company on which an audit was not performed. Now, a privately held company may engage a CPA to perform one of three types of services with respect to the company's financial statements:

1. Compilation services in which the CPA's report gives *no* assurance,
2. Review services in which the CPA's report gives *limited* assurance, or
3. Audit services in which the CPA's report gives *positive* assurance.

SSARS No. 1 has been called "revolutionary" and it has been predicted that it will "affect the conduct of practice related to nonpublic companies more than any other pronouncement in recent years."[2] Yet the question has been raised as to whether the users can understand the differences between the three different reports.[3] If users do not understand the differences in the nature of the accountant's services and therefore cannot correctly discern the level of assurance in the accountant's report, then confusion could exist. As noted by Libby,[4] if the user does have misperceptions of the message which the CPA intends to communicate, then perhaps the user will make different decisions than those that would be made if the report were correctly perceived. Thus the user might place unwarranted reliance on the compilation or review report. Additionally, the accountant's legal liability might be increased due to the miscommunication.

To discern whether users can interpret and understand the two new reports, a survey was conducted of preparers (CPAs) and users (bankers) of the reports. The objective of this article is to summarize the results of this research and its implications for practitioners.

THE SURVEY GROUPS

The accountant's report is the primary means of communication between the accountant and the users of the financial statements which accompany the report. In order to determine if there were perceptual differences between the preparers and users of the reports, we surveyed a random sample of 250 CPAs and 250 bankers. Responses were received from 102 CPAs (forty-one percent) and 122 bankers (forty-nine percent).

Bankers were selected as the survey user group since the compilation and review reports may only be issued in connection with financial statements of nonpublic entities. The primary users of these financial statements were assumed to be credit oriented users (i.e., banks and financial institutions). All of the bankers in the survey had experience in making lending decisions. The relative experience levels of the survey respondents are summarized in Table 1.

THE SURVEY

The CPAs and bankers were given copies of four different accountant's reports:

1. A disclaimer of opinion.
2. An unqualified opinion.
3. A review report.
4. A compilation report.

Each report was followed by a series of statements concerning various aspects of the report. The participants were asked to agree or disagree with the statements utilizing a seven point scale where 1 indicated complete agreement with the statement, 4 indicated the participant was undecided and 7 indicated complete disagreement. These statements were designed to determine the respondent's perceptions of each report in four general areas:

1. The extent of the accountant's examination,
2. The level of assurance given by the accountant,
3. The usefulness of the report, and
4. The accountant's legal liability.

The perceptions of the CPAs and bankers in each of these areas were compared utilizing the mean response of each group to determine if their perceptions of each report were consistent. In other words, did the CPAs and bankers perceive the compilation report the same way? Their responses were then compared across the reports to determine if they consistently ordered the reports in the four areas listed above. In other words, did the CPAs and bankers consistently view the accountant's examination as being the lowest for the disclaimer and compilation, somewhere in the middle for a review, and at its highest level for an unqualified opinion?

Can the Reports be Distinguished?

The survey reflected that, in general, the CPAs and bankers can distinguish between the reports. This was shown by the fact that both groups consistently recognized that the extent of the accountant's examination was lowest for a compilation or disclaimer, in the middle for a review and highest for an unqualified opinion. This ordering of the reports was also consistent in their perceptions of the level of assurance and the usefulness of the reports. It is interesting to note that, in most cases, both the CPAs and bankers ranked the compilation report below the disclaimer report although the differences in the rankings were not significant. This might result from the fact that the compilation report is couched in more wary terms than the disclaimer and that the procedures applied by the accountant are very limited. In any case, both groups appear to view these two reports with the caution that they deserve.

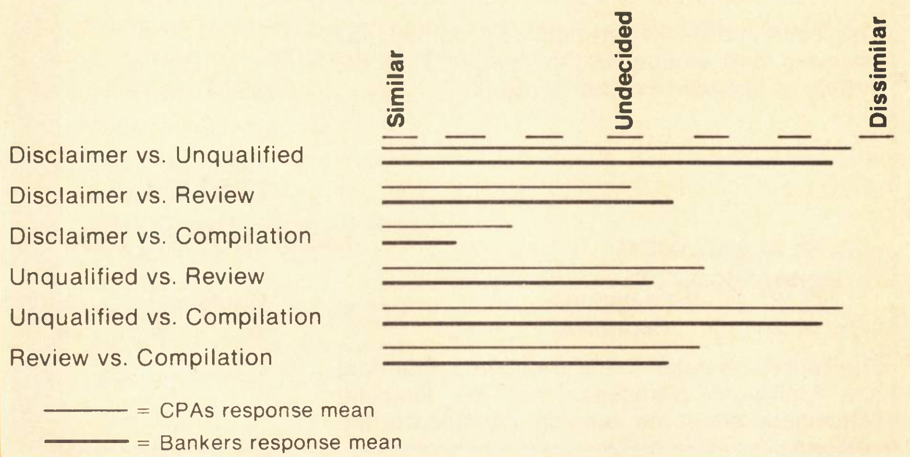
Both groups appeared to be able to recognize the review report as being a form of assurance which is unlike the other three reports. However, the report does not appear to be as well understood and consistently interpreted as the other three forms of report. This conclusion is supported by several survey results.

First, recall that a mean answer of 4 on the questionnaire would indicate an undecided position. A mean answer of 4 could result for two reasons. First, the participants could be truly undecided with respect to the question and thus a mean of 4 could result if most of the survey participants responded with an answer of 4. Second, part of the group could perceive the report one way (for instance agree with the statement and answer 1 or 2) and another part of the group could perceive the report the opposite way (for instance disagree with the statement and answer 6 or 7). The total group answers would then average around 4. A standard deviation of 2 or more would indicate the second explanation was exhibited in the responses. Both CPAs and bankers responded to more questions concerning the review report with a mean answer grouped around 4 than to any of the other reports. Additionally more questions had a standard deviation of 2 or more for the review report than for the other three forms of reports.

TABLE 1
Experience Level of Respondents

Years of Experience	CPAs' Public Accounting Experience	Bankers' Commercial Lending Experience
1 to 3	0.0%	20.7%
4 to 6	8.9	21.5
7 to 9	18.6	12.4
10 or more	72.5	45.4
	100.0%	100.0%

TABLE 2
Similarities of Reports



Second, the groups were asked to compare the reports as to the degree of similarity and dissimilarity. These results are presented in Table 2 and, once again, it appears that both groups were undecided as to how to interpret the review report in comparison to the other three reports. This indecision was also indicated by an inspection of the standard deviation of the responses to comparisons summarized in Table 2. The responses of both groups had larger standard deviations for the three comparisons involving the review report than for the other three report comparisons tabulated.

The indecision or uncertainty pertaining to the review report is not surprising. This report is new and it reflects a *limited* form of assurance which is very much unlike that given in the forms of reports which were generally available before SSARS No. 1 (i.e., the unqualified, qualified and disclaimer reports). It therefore could be expected that it will take time for both preparers and users to become familiar with the limitations associated with the review type of engagement.

The CPAs and bankers also differed with respect to the *degree* to which they rely upon each report. For instance, the CPAs and bankers consistently felt financial statements were comparatively less reliable when accompanied by a disclaimer or compilation than when accompanied by an unqualified report; but the bankers felt the statements were less reliable than the CPAs for all four forms of reports. These differences are discussed in the following paragraphs.

The Extent of the Accountant's Examination

Table 3 summarizes the general perceptions of the CPAs and bankers as to the procedures performed by the accountant for each type of report. The respondents appeared to have a good grasp of the differences in the accountant's examination in each of the four cases. Both groups agreed that the review

TABLE 3
Procedures Performed in the Examination

Procedures Performed	Disclaimer A	Disclaimer B	Compilation A	Compilation B	Review A	Review B	Unqualified A	Unqualified B
The report is based primarily on inquiry and analytical procedures such as financial ratio analysis.	5.0	5.6	6.1	6.1	2.0	3.0	5.9	4.2
The report indicated that the public accountant performed verification tests of the accounting records and other necessary procedures in order to insure that the financial statements adequately represent the financial condition of the company.	6.6	6.6	6.7	6.6	5.9	5.5	1.1	1.2
The report implies that the public accountant has reviewed and evaluated the adequacy of the system of financial internal controls.	6.6	6.4	6.6	6.6	5.8	4.8	1.4	1.4

TABLE 4
Level of Assurance

Procedures Performed	Disclaimer A	Disclaimer B	Compilation A	Compilation B	Review A	Review B	Unqualified A	Unqualified B
The report indicates that the public accountant has expressed confidence that the financial statements reflect the financial condition of the company.	6.3	6.5	6.5	6.6	4.7	5.0	1.3	1.4
The financial statements referred to in the report are the representation of the public accountant.	6.5	6.4	6.4	6.6	6.5	5.8	6.0	3.0
The report indicates that the financial statements are free from material errors or omissions.	6.0	6.4	6.4	6.5	4.2	4.6	1.8	2.1
The report indicates that the financial statements are in conformity with GAAP.	4.9	6.3	5.3	6.3	2.8	4.3	1.1	1.3
The report indicates that the financial statements present fairly the financial condition of the company.	6.4	6.4	6.4	6.5	4.9	5.1	1.1	1.3

A = mean response of CPAs
B = mean response of Bankers
Where: 1 represents agreement and 7 represents disagreement with the statement.

report was based primarily upon inquiry and analytical procedures. This is not surprising since there is an explicit statement to that effect in a review report. Additionally, both groups recognized that the unqualified report was the only one which was based on verification tests of the accounting records and in which a review of internal control was made.

The Level of Assurance

The participants were asked to respond to a series of five statements which dealt with the level of assurance and the extent of the accountant's responsibility with respect to each report. The results are presented in Table 4. Both the CPAs and bankers perceived that only in an unqualified report did the accountant express confidence that the financial statements reflected the financial condition of the company, were free from material misstatements and fairly presented the financial condition of the company. However, there was less conformity in the CPAs and bankers views in two other areas.

First, the bankers felt that, in general, as the level of assurance increases, the financial statements become the representation of the accountant. As shown in Table 4, there was a clear dichotomy of views with respect to this question for the unqualified opinion. The CPAs felt that in all four reports, the financial statements were *not* the accountant's representation. The bankers felt the financial statements were the respresentation of the accountant in the case of an unqualified opinion.

The current exposure draft of suggested changes in the short form opinion by the Auditing Standards Board attempts to correct this type of misinterpretation by including an explicit statement saying that the financial statements are management's representation.

A second area of difference concerned the extent of the financial statement's conformity with GAAP. The CPAs felt that the report indicated the statements were in conformity with GAAP for both the review and the unqualified report, although they agreed more strongly with this statement in the case of an unqualified opinion than for a review. This might indicate that the CPAs interpret the limited assurance of a review as being an indication (although somewhat weak) that the statements are in conformity with GAAP. The bankers do not appear to gain that degree of confidence. Rather, the banker's responses indicated that, in general, only the unqualified report gave positive assurance as to conformity with GAAP.

Usefulness of the Reports

A series of questions were asked to discern the extent to which the various reports aided in evaluating the quality of the accompanying financial statements.

How reliable are the financial statements?

Bankers generally felt that the financial statements were less reliable than CPAs. In the case of those statements accompanied by a compilation or disclaimer report, the bankers were undecided as to their reliability. CPAs in all cases felt that the statements had some degree of reliability and felt that reliability increased as the level of assurance (i.e., the type of report) increased.

Do the statements contain management bias?

The bankers, across all four reports, felt the statements were more biased than did the CPAs. Both groups felt this bias was alleviated only in the case of an unqualified report.

The answers to both of the questions discussed above appear to indicate that the bankers place less faith in the financial statements than do the CPAs, regardless of the form of the accountant's association with those statements. This skeptical orientation of the bankers is understandable given that they utilize the statements in making credit decisions and they generally have more sources of input into that decision than just the financial statements. Hence the statements alone possess less credibility to the bankers.

Does the report affect the quality of the company as a loan prospect?

The bankers consistently viewed the accountant's report as having a stronger impact on their evaluation of the quality of the company than did the CPAs. The bankers felt that a disclaimer, a compilation and an unqualified report would have more of an impact in this area than a review. This appears to be consistent with the fact that the disclaimer and compilation give no assurance and an unqualified opinion gives positive assurance. For these three forms of reports, there is a clear-cut line of demarcation and this information would be helpful in evaluating the quality of the company as a loan prospect. The review, being only a limited assurance, would be of less use than the other two forms of assurance. The accountants were undecided as to impact of a disclaimer and a compilation, felt the review would have some impact and the unqualified report the greatest impact in this evaluation.

Is the riskiness of the company affected by the report?

The bankers, indicated that the accountant's report would affect their evaluation of the riskiness of the company in all four cases. The CPAs indicated that, in every case, the riskiness of the company would be unaffected by the report.

The dichotomy in the survey responses to the preceding two questions indicates that the bankers, in evaluating financial statements, place more reliance or emphasis on the accountant's report than the CPAs perceive. If this is indeed true, then it seems to be imperative that the report clearly communicate the accountant's intended message. The survey results are a preliminary indication that there exists some danger of misinterpretation of the review report. This danger is highlighted by a recent study which reported that 28 percent of those companies which previously submitted *unaudited* statements to bankers are now undergoing reviews and about 25 percent of those companies which previously submitted *audited* statements are now undergoing compilations or reviews.[5] Based upon these numbers, it appears likely that reviews will be utilized in many credit decisions.

To insure that problems are not encountered due to misinterpretation of the limits of a review, the efforts currently being made by the accounting profession to educate both the preparers and users of the report are imperative and should be continued. The participation of practitioners in this educational effort is needed since they have day to day contact with the users of the report. The practitioner can participate by contributing articles which explain the limitations of the review engagement to professional journals which are read by clients and the users of their financial statements. In addition, the practitioner should, as always, make every effort to aid the client in identifying what the needs are of the users of their financial statement in order to insure that the type of service provided by the CPA meets those needs. The study[6] recently completed under the sponsorship of Fox & Company, to be published as an Auditing Research Monograph by the AICPA, should aid the practioner in this counseling effort. The study found, in part, that the following factors affect the accounting service decision:

Bankers:

1. "Loan size, and to a lesser degree the customer's capitalization and the bank's previous relationship with the customer, are the most significant factors used by bankers to determine whether a compilation, review or audit will be required in connection with loans.

2. Compilation or review, in lieu of an audit, is more likely to be acceptable when the borrower is profitable, the loan is well secured and the customer and CPA firm are respected by the banker.

CPAs:

1. When advising a client on a potential change from an audit to a compilation or review, prior audit experience and adequacy of internal controls are the most important factors used in determining the advice to be given.

2. When recommending the needed level of service for clients who received unaudited financial statements prior to SSARS 1, the most influential factors are the perceived needs of third party users, prior experience with the client, and adequacy of the system of internal control."[7]

Legal Liability

Neither the bankers nor the CPAs in our survey felt that lawsuits were likely to result from reliance on the accountant's reports. However, the accountants held this position less strongly for the review and unqualified reports than for the compilation and disclaimer. The perceptions of the accountants appear reasonable in view of the fact that in these two reports, they express assurance and, therefore, the relative probability of lawsuits should be higher than for those reports which give no assurance.

CONCLUSION

The results of our survey indicate that both CPAs and bankers consistently order the four forms of accountant's reports which were presented to them and that they possess a good understanding of the meanings of the reports. However, the survey results provide a preliminary indication that the review report is not as well understood by the CPAs and bankers as the other three forms of reports. We encourage continued efforts to refine the report and to educate the preparers and users of the review report concerning the benefits and limitations of the new form of accounting service. In addition, continued monitoring of the perceptions of the preparers and users of the review report is needed until sufficient time has passed to permit complete familiarization with the report and to insure that it is well understood.Ω

FOOTNOTES

[1]Statement on Standards for Accounting and Review Services no. 1, (SSARS no. 1), *Compilation and Review of Financial Statements* (New York: AICPA, 1979).

[2]Robert L. Israeloff, "Practitioners' Answers to Compilation and Review," *CPA Journal,* November, 1979, p. 29.

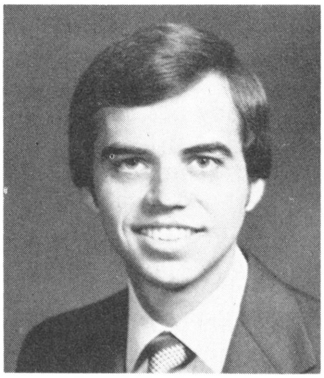
[3]Harry G. Brown, "Compilation and Review - A Step Forward?" *CPA Journal,* May, 1979, p. 23.

[4]Robert Libby, "Bankers' and Auditors' Perceptions of the Message Communicated by the Audit Report," *Journal of Accounting Research,* Spring, 1979, p. 100.

[5]Jerry L. Arnold and Michael A. Diamond, reported in "News Report," *Journal of Accountancy,* October, 1980, p. 8.

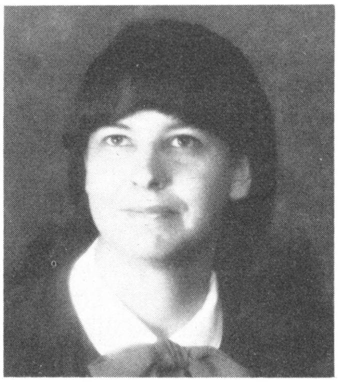
[6]Ibid. and referred to in "Attitudes and Perceptions: Compilation and Review One Year Later" (an Executive Summary), Fox & Company, Certified Public Accountants, 1980.

[7]Ibid.



Thomas P. Edmonds, *Ph.D., is assistant professor in the Department of Accountancy and Taxation at the University of Houston. He acts as an education consultant for the First City National Bank of Houston, and has published in various banking and accounting journals.*

Ira R. Weiss, *CPA, Ph.D., is assistant professor in the Department of Accountancy and Taxation at the University of Houston. His publishing credits include articles on auditing and systems, which have appeared in accounting journals.*



Mattie C. Porter, *CPA, Ph.D., is assistant professor in the Department of Accountancy and Taxation at the University of Houston. She has been with the staff of Peat, Marwick, Mitchell & Co., is a member of AICPA, and has contributed articles to a number of accounting journals.*