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WAS THE ACCOUNTING PROFESSION REALLY THAT BAD?

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ABSTRACT

To gain insight into the extent of malpractice in the State of California prior to the Passage of Sarbanes-Oxley, we examined the nature and magnitude of complains filed with the California Board of Accountancy (CBA) against both licensed and unlicensed accountants during the fiscal years 2000, 2001, and 2002. The CBA currently licenses and regulates over 73,000 licenses, with 1,431 complaints filed during the period reviewed.

Disciplinary actions were taken against 283 different licensees for the three fiscal years reviewed. SEC issues were involved in 19 cases, theft or embezzlement 46 cases, public accounting malpractice 146 cases, improper retention of client records 11 cases, cheating on the CPA examination 9 cases, and miscellaneous other 52 cases.

Over half of the complaints involved public accounting issues. Audit related complaints accounted for 48%, tax related complaints 36%, and compilations or reviews accounted for 16% of the complaints. These statistics were in line with the experience of the AICPA Professional Liability program.

Within the above sections, the paper contains specifics with regards to the most common problems identified as a result of this work. While a number of interesting facts were discovered, one item of particular interest was the significant number of claims that involved non-profit organizations. CBA administrators do not believe there is any greater tendency for non profit reporting versus for profit reporting, thus appearing to indicate this is just an area that has a greater possibility of accounting malpractice.

INTRODUCTION

In an attempt to restore public trust in the accounting profession and investor confidence in the financial markets, Congress enacted the Public Company Accounting Reform and Investor Protection Act of 2002, better known as the Sarbanes-Oxley Act (SOX). Prior to the enactment of this legislation, there was a perceived crisis in the credibility of the auditing profession given the newsworthy scandals such as Enron, WorldCom, and Global Crossing. Tax preparers also fall prey to the media attacks as evidenced by a *USA Today* front page headline, "Many Burned by Inept or Crooked Tax Preparers" (McCoy, 2006).

To gain insight into the extent of malpractice in the State of California prior to SOX, we examined the nature and the magnitude of complaints filed with the California Board of Accountancy (CBA) against both licensed/unlicensed accountants during the fiscal years-ended 2000 through 2002. In addition, we reviewed the corresponding disciplinary actions taken by the CBA related to these complaints.

BACKGROUND OF THE CBA

The CBA currently licenses and regulates more than 73,000 licensees, the largest group of licensed accounting professionals in the nation, including individual Certified Public Accountants (CPAs) and Public Accountants (PAs). The CBA's stated mission is to "protect the public welfare, particularly consumers, by ensuring that only qualified persons and firms are licensed to practice public accountancy and that appropriate standards of competency and practice, including ethics, objectivity and independence are established and enforced." As part of this mission, the CBA is responsible for initiating and investigating complaints against individuals practicing public accounting in California.

When the CBA receives a complaint, an investigation is usually conducted by their Enforcement Division. The Enforcement Division is staffed by professional investigative CPAs holding strong backgrounds in accounting practices and professional standards. In addition to investigating complaints, the Enforcement Division also provides testimony at administrative hearings and monitors compliance of those accountants placed on probation. Following an investigation by the Enforcement Division, and subsequent administrative hearings, the CBA has the option of revoking or suspending the individual's license or placing the CPA/PA on probation. If probation is violated, the CBA has the option of revoking probation and implementing the disciplinary action that was originally stayed.

STUDY RESULTS

Nature of Complaints Filed

During the fiscal years-ended 2000, 2001, and 2002, the CBA received 510, 409, and 492 complaints, respectively. The table below lists the number of cases that were closed by the CBA without a formal hearing. At the end of this study, 88 investigations still remained open ("The Risk Management Resource", 2003). As the table below indicates, the number of complaints filed represents a very small percentage (less than 1 percent) of licensees in the state.

For these three fiscal years, we reviewed the nature of complaints and disciplinary actions taken against 283 different individual licensees. The nature of the complaints examined covered a broad range of areas including: SEC regulations, embezzlement, malpractice, improper retention of client records and cheating on the CPA examination. The breakdown of the nature of the complaint filed is summarized in the table below:

Descriptive Statistics of Complaints Filed with CBA		Y/E	
	2000	2001	2002
Number of complaints filed	510	409	492
Percentage of total licensees	.69%	.56%	.67%
Number of cases closed with no formal hearing	360	305	295

Description of the Complaint	# of Cases	% of Total
Issues with SEC regulations	19	6.7%
Stealing assets or embezzling funds	46	16.3%
Public accounting malpractice	146	51.6%
Improper retention of client records	11	3.8%
Cheating on CPA exam	9	3.1%
Other	52	18.3%
TOTAL	283	100%

Of the individuals in the sample who had actions taken against them, 6.7% had issues involving Securities and Exchange regulations. The most common problems identified in these complaints with accountants in private practice were inflating earnings, providing false and or misleading information and improper revenue recognition. For accountants in public practice, the most common problems were gross negligence in the conduct of the audit and the lack of independence. The lack of independence is cause for concern, because the ethical topic is covered in an introductory auditing course and the subject is still stressed in continuing education courses. Another potential cause for concern was the finding that of the 283 individuals who received disciplinary action, 16.3%, had been involved with either stealing assets or embezzling funds. Examples of such activities included: embezzling school funds in the amount of \$47,000 while acting as a volunteer (3 complaints involved the actions of volunteers); stealing \$800,000 of a client's funds; getting a client to invest \$500,000 in a phony real estate project, in which the accountant received the entire investment funds; stealing \$860,000 of church funds; stealing credit cards and cash from other firm partners; and fraudulently billing Medicare. Money laundering and securities fraud was also committed in a number of cases.

Over half of the complaints involved public accounting issues. Auditing related complaints accounted for 48%, tax related complaints accounted for 36%, and compilations or reviews complaints accounted for 16% of the cases reviewed. These statistics are consistent with the experience of AICPA Professional Liability program, which reported that audits continue to be the highest area for malpractice claims under its program, both in terms of claim frequency (how often

a claim occurs per revenue dollar) and in claim severity (the average cost per claim) (“Update”, 2003).

Descriptions of the complaints filed in each of the accounting functions are outlined below:

AUDITING

Gross negligence in the performance of audits

Failure to comply with GAAS

Failure to comply with GAAP

TAX

Late filing of tax returns

Failure to file tax returns

Omitting substantial amounts of known taxable income

Taking incorrect tax deductions

Preparing false or fraudulent tax returns

Preparing 2 sets of tax return to mislead a 3rd party

Backdating supporting documents

COMPILATION AND REVIEWS

Gross negligence, fraud

Failure to include all applicable financial statements

Lack of independence

The most common problems in the audit area were gross negligence in the performance of audits, failure to comply with GAAS (Generally Accepted Accounting Standards) or failure to follow GAAP (Generally Accepted Accounting Principles). Within the audit area, a significant number of the disciplinary actions were related to non-profit audits. Twenty-seven of the seventy-six audit related cases, involved audits of non-profit organizations such as school districts, city or county government, homeowners associations, HUD, student loan programs, retirement plans, and foundations. One of the CBA’s chief investigators was of the opinion that non-profit entities were no more likely than any other group to file complaints. He added that the IRS and FTB rarely reported such information to the CBA.

Within the tax area, there were several common problems as noted in the aforementioned categories of complaints. The following three examples will serve to illustrate the nature of tax related complaints. In one case, the tax preparer failed to take a stepped up basis for an inherited asset and failed to take a deduction for the estate taxes paid on income with respect to a decedent. In a second case, a tax preparer incorrectly advised a client to purchase a home for their son, to avoid paying capital gains tax on the sale of their personal residence. In a third case, a tax preparer failed to claim

a state tax credit on an estate tax return. Based on previous findings, these cases reflect problems that are quite common among tax professionals (Donnelly, O'Callaghan, Walker, 1999).

With respect to compilation and reviews, in some cases it could not be determined whether or not the deficiency was for compiled or reviewed statements. Based on the information available, at least nine of the twenty-four complaints involved review work. As noted above, gross negligence, fraud, failure to include all applicable financial statements, and lack of independence (a requirement for a review report) were among the most common problems in this area.

Another common complaint involved the improper retention of client records, which according to Rule 501 is a discreditable act. A client has a right to demand return of their documents, at any time they choose. However, some accountants are under the false impression that they can hold the client records hostage, usually demanding payment for services before the documents will be returned. Nothing could be further from the truth. The accountant only has the right to retain his/her work product.

While not a major cause for CBA actions, nine of the cases involved cheating on the CPA examination. In most cases the individuals were caught during the examination. Unbelievably, one individual was caught cheating on three different occasions and another was caught cheating twice. In other cases, the CBA identified the cheating as a result of their statistical evaluation of examination results.

Disciplinary Actions by the CBA

Given the severity of many of these complaints, one would expect harsh penalties imposed by the CBA. On the contrary, of the 283 individuals who had disciplinary action taken against them, only 183 lost their license. Loss of license, the most severe disciplinary action, represented only .25% of the total licensees in California over a three year period. With the exception of fraud and embezzlement cases, the CBA had an apparent tendency to grant licensees a second chance to redeem themselves. For example, seventeen individuals simply had their licenses suspended, despite multiple complaints and/or violations of the terms of their probation. Of course, an exception to the CBA's apparent disciplinary laxity was the revocation of Arthur Andersen's license as the result of their involvement with the Enron scandal. However, in a number of cases, one could question why more licenses were not suspended. Clearly the CBA will only take away an accountant's ability to earn a living as a last resort, when the actions of that individual indicate a stricter penalty may be warranted.

CONCLUSION

When one considers the number of licensed accounting professionals in California, the total number of complaints filed during these three years is relatively small. Even if one factors in a number for additional complaints that weren't filed for various reasons, we conclude the number of complaints filed with CBA and the number of resulting disciplinary actions taken by CBA appears inconsequential. Contrary to what many politicians and media pundits have led the public to believe, the accounting profession, at least in California, was really not that "bad" at the time SOX was enacted.

By no means does this conclusion suggest that SOX was unwarranted. SOX brings a wake up call to the accounting profession. The intent of the legislation is to help recapture the public trust that was lost during the financial markets bubble. We believe additional steps are needed at the state level in order to restore confidence in the profession. Another issue that needs to be addressed is whether or not there is a tendency by state boards of accountancy, such as the CBA, to minimize their disciplinary actions against individual practitioners and firms, who have not exhibited the highest levels of ethical behavior and professional competency. The old adage “actions speak louder than words” is most appropriate, given the public’s current perception of the profession. If the public believes that accounting professionals can get away with financial murder, without being held accountable and appropriately reprimanded, then not only will the lost trust never be regained, but the possibility of further Congressional legislation becomes ever more likely.

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