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by

Arthur M. Magaldi

As life in the latter stages of the twentieth century has become more complex and financial transactions more intricate, the role of the accountant has grown in importance. With financial and economic complexity has come the need to independently verify the assertions of those involved in business transactions. Indeed, statutes often require that parties submit audited financial statements, for example, when registering a new issue of securities with the SEC for sale to the public by means of interstate commerce. In other transactions like loans to businesses, audited financial statements are routinely required. In many ways, CPAs are considered the guardians of the financial integrity of our institutions.

As the accounting profession has grown in importance, the Uniform CPA Examination has similarly become more important. "The Uniform CPA Examination is the primary means used by the boards of accountancy to measure the technical competence of CPA candidates. To understand the importance of the examination as a prerequisite for the CPA certificate, one must recognize the significance of the certificate. It is awarded in the public interest to qualified candidates in accordance with the accountancy statutes of a given jurisdiction. The certificate is granted to ensure the professional competence of individuals offering their services to the public as professional accountants."

The Uniform CPA Examination is given each year in May and November and has four distinct parts. A candidate must show competency in all four parts of the examination.
examination by scoring a mark of at least 75 percent on each part of the test. For the years 1988-1993, the various parts of the examination were Accounting Practice, Accounting Theory, Auditing, and Business Law.

The Business Law section of the examination is the focus of this paper. The topics tested and the respective weights given to those topics for the years 1988-1993 were as follows:

<table>
<thead>
<tr>
<th>The CPA and the Law</th>
<th>10 Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Organizations</td>
<td>20 Percent</td>
</tr>
<tr>
<td>Contracts</td>
<td>15 Percent</td>
</tr>
<tr>
<td>Debtor-Creditor Relationships</td>
<td>10 Percent</td>
</tr>
<tr>
<td>Government Regulation of Business</td>
<td>10 Percent</td>
</tr>
<tr>
<td>Uniform Commercial Code</td>
<td>25 Percent</td>
</tr>
<tr>
<td>Property</td>
<td>10 Percent</td>
</tr>
</tbody>
</table>

Of course, each main topic has various sub-topics.3

Traditionally, the Business Law section of the examination consisted of 60 percent objective questions presented in a multiple choice format and 40 percent essay questions. In 1992, the test was changed to a format of 70 percent objective questions and 30 percent essay questions. The additional 10 percent objective questions are so-called "other objective" questions since they are not multiple choice questions. Nevertheless, they are essentially "blacken the oval" variations of multiple choice questions.

Although the importance of the Uniform CPA Examination is understood, the content of the examination has had relatively little critical evaluation. An examination of such importance should meet the highest standards of reliability and validity. This paper scrutinizes the multiple choice portion of the examination for the twelve-exam period from November 1988 through May 1993. Emphasis will be placed on those questions considered inappropriate and an attempt will be made to evaluate the overall reliability and validity of those tests.

The CPA Examination is not intended to be comparable to a bar exam. The AICPA has indicated, "The Business Law section is chiefly conceptual in nature and is broad in scope. It is not intended to test candidates' competence to practice law or their expertise in legal matters, but to recognize relevant issues, recognize the legal implications of business situations, apply the underlying principles of law to accounting and auditing, and know when to seek legal counsel or recommend that it be sought. This section deals with federal and widely adopted uniform laws. Where there is no federal or appropriate uniform law on a subject, the questions are intended to test candidates' knowledge of the majority rules."4

Analysis of the objective portion of the twelve examinations administered between May 1988 and November 1993 reveal a number of inappropriate questions. These questions do not meet the standards established by the examiners for the examination.

Questions which detract from the fairness and effectiveness of the examination are for the purposes of this discussion characterized as follows: questions in which the material tested is outside the scope of the examination; questions in which there is more than one correct or "right" choice and therefore no best choice; questions in which all answer choices are incorrect; questions in which the wording is unreasonably unclear or confusing; questions which are concerned with impractical or irrelevant fact patterns or scenarios.

**Question Outside the Scope of the Examination**

For the twelve examinations from 1988-1993 inclusive, the examiners asked several questions which were clearly not included in the Content Specification Outline provided for candidates. Question #60 from May 1990 is set forth below and tests the concept of insurable interest in life insurance.

60. **Orr** is an employee of **Vick Corp.** Vick relies heavily on **Orr's** ability to market Vick's products and, for that reason, has acquired a $50,000 insurance policy on **Orr's** life. Half of the face value of the policy is payable to **Vick** and the other half is payable to **Orr's** spouse. **Orr** dies shortly after the policy is taken out but after leaving **Vick's** employ. Which of the following statements is correct?

a. **Orr's** spouse does not have an insurable interest because the policy is owned by **Vick**.

b. **Orr's** spouse will be entitled to all of the proceeds of the policy.

c. **Vick** will not be entitled to any of the proceeds of the policy because **Vick** is not a creditor or relative of **Orr**.
d. Vick will be entitled to its share of the proceeds of the policy regardless of whether Orr is employed by Vick at the time of death.

Although a relatively simple question, the fault in this question is that the only insurance concepts on the content specifications outline concern fire and casualty insurance. Question #80 concerns life insurance, a concept which was outside the scope of the examination.

The error of including life insurance concepts on the exam is repeated in Question #23 on the May 1993 examination and is set forth below.

23. Long purchased a life insurance policy with Tempo Life Insurance Co. The policy named Long's daughter as beneficiary. Six months after the policy was issued, Long died of a heart attack. Long had failed to disclose on the insurance application a known pre-existing heart condition that caused the heart attack. Tempo refused to pay the death benefit to Long's daughter. If Long's daughter sues, Tempo will:

a. win, because Long's daughter is an incidental beneficiary.
b. lose, because of Long's failure to disclose the pre-existing heart condition.
c. lose, because Long's death was from natural causes.
d. lose, because Long's daughter is a third-party donee beneficiary.

Perhaps the most extreme example of questions clearly outside the scope of the content specifications guidelines is Question #8 from the November 1992 examination. This esoteric question tests candidates on a topic that can be found in virtually none of the leading business law textbooks and concerns a point of law which lawyers traditionally have difficulty understanding - The Rule Against Perpetuities. It should be noted that this question might also be included in the section on questions which are not relevant to the practice of a CPA.

8. To which of the following trusts would the rule against perpetuities not apply?

a. Charitable.
b. Spendthrift.
c. Totten.
d. Constructive.

The correct answer choice is “a” but the more important point is that the concept does not belong on the exam.

More Than One Best Choice

Question #21 from the November 1989 examination tests the suretyship concept of the rights of a surety who has satisfied the obligation of a debtor and is set forth below.

21. If a debtor defaults and the debtor's surety satisfies the obligation, the surety acquires the right of:

a. subrogation.
b. primary lien.
c. indemnification.
d. satisfaction.

In the instance where a surety satisfies an obligation the surety is entitled to the right of subrogation (choice "a"), i.e., the right to succeed to the creditor's rights against the debtor. A surety who satisfies the obligation of the debtor is also entitled to indemnification (choice "c") from the debtor.

The above illustration is the only instance on the twelve examinations in question in which the examiners erred in providing two choices which were equally correct. The question therefore provides no best answer.
Questions in Which All Answer Choices Are Incorrect

Question #60 from the May 1991 examination deals with secured transactions under Article 9 of the UCC. Specifically, the question concerns the rights of a secured creditor who has perfected by the filing of a financing statement a security interest in a transaction involving a purchase money security interest of consumer goods.

UCC Sec. 9-302(1)(d) provides that a creditor who obtains a purchase money security interest in a consumer goods transaction is automatically deemed to have its interest perfected at the time attachment takes place. No filing of a financing statement is required in such a case. If the consumer-debtor should, however, repossess the collateral to another consumer who in good faith is ignorant of the security interest, the security interest is defeated (if unfilled). To obtain protection against sub-purchasing consumers of this type, the secured creditor must file a financing statement. Where no filing of a financing statement takes place in a situation concerning a purchase money security interest of consumer goods, the security interest is deemed perfected upon attachment, but it is subject to defeat by a good faith consumer-purchaser from the original debtor.

60. Wine purchased a computer using the proceeds of a loan from MJC Finance Company. Wine gave MJC a security interest in the computer. Wine executed a security agreement and financing statement, which was filed by MJC. Wine used the computer to monitor Wine's personal investments. Later, Wine sold the computer to Jacobs, for Jacobs' family use. Jacobs was unaware of MJC's security interest. Wine now is in default under the MJC loan. May MJC repossess the computer from Jacobs?

a. No, because Jacobs was unaware of the MJC security interest.
b. No, because Jacobs intended to use the computer for family or household purposes.
c. Yes, because MJC's security interest was perfected before Jacobs' purchase.
d. Yes, because Jacobs' purchase of the computer made Jacobs personally liable to MJC.

The examiners offer choice "c" as the correct answer. However, the answer along with the other choices is not a correct statement of law. The secured creditor may repossess not simply because the interest was perfected before Jacobs purchased, since that perfection was automatic. The collateral may be repossessed by the secured creditor because the security interest was perfected by filing. Question #60 does not mention filing in any of the answer choices.

Questions Which Are Unclear or Confusing

In general, the examiners are clear and straightforward in the wording of questions. Question #60 from May 1989 was somewhat unclear, however, and again deals with a secured transaction.

60. Burn Manufacturing borrowed $500,000 from Howard Finance Co., secured by Burn's present and future inventory, accounts receivable, and the proceeds thereof. The parties signed a financing statement that described the collateral and it was filed in the appropriate state office. Burn subsequently defaulted in the repayment of the loan and Howard attempted to enforce its security interest. Burn contended that Howard's security interest was unenforceable. In addition, Green, who subsequently gave credit to Burn without knowledge of Howard's security interest, is also attempting to defeat Howard's alleged security interest. The security interest in question is valid with respect to:

a. both Burn and Green.
b. neither Burn nor Green.
c. Burn but not Green.
d. Green but not Burn.

Here the question tells the candidates that a loan was "secured" and a financing statement was signed and filed. The question does not indicate that a security agreement was signed by the debtor. Since an oral security agreement is enforceable only if the creditor has, or takes, possession of the collateral, the argument can be made that no property enforceable security interest exists. The examiners find that there is a properly enforceable security interest making choice "a" their correct answer.

Inasmuch as many candidates focus on the signed security agreement as pivotal to creation of a security interest, the question may justifiably be criticized as unclear.

Also unclear or confusing is Question #13 from November of 1993.
13. Generally, a disclosed principal will be liable to third parties for its agent's unauthorized misrepresentations if the agent is an:

<table>
<thead>
<tr>
<th>Employee</th>
<th>Independent Contractor</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>b. Yes</td>
<td>No</td>
</tr>
<tr>
<td>c. No</td>
<td>Yes</td>
</tr>
<tr>
<td>d. No</td>
<td>No</td>
</tr>
</tbody>
</table>

The confusion concerning this question stems from the fact that the narrative portion of the question describes agents working for a disclosed principal and is concerned with the liability of a disclosed principal for the unauthorized misrepresentations of agents. By definition, an agent is a party authorized to make contracts and a principal is generally bound by the unauthorized misrepresentations of agents. The student is then forced to choose as a correct answer choice "b" because of the inclusion of the term "independent contractor." Since an independent contractor is not an agent, it is confusing to apply the term "agent" to that relationship.

Questions Lacking in Relevancy

The area where the examiners apparently have the most difficulty is in consistently providing questions which are relevant to the practice of a CPA. As previously noted, relevancy of material is one of the criteria for the questions.

Despite the need for relevant questions, on four different occasions on the analyzed examinations the examiners posed questions on the legal result of a creditor releasing one surety in a situation where there are two or more sureties for an obligation. Question #26 from the November 1991 examination set forth below is illustrative of this type question.

26. Mane Bank lent Eller $120,000 and received securities valued at $30,000 as collateral. At Mane's request, Salem and Rey agreed to act as uncompensated co-sureties on the loan. The agreement provided that Salem's and Rey's maximum liability would be $120,000 each.

Mane released Rey without Salem's consent. Eller later defaulted when the collateral held by Mane was worthless and the loan balance was $90,000. Salem's maximum liability is:

a. $30,000.
b. $45,000.
c. $60,000.
d. $90,000.

The best answer choice for Question #26 is "b" because a creditor who releases a surety from an obligation where there are two or more sureties may not collect the full amount from the unreleased surety or sureties. The amount that may be recovered from the unreleased surety or sureties is reduced by the amount of contribution that otherwise would have been recoverable from the released surety had that surety not been released.

The difficulty, however, with this question is that it has virtually no relevance in the business world since those engaged in business transactions do not release obligors from their obligations. Question #26 from May 1991, Question #26 from November 1991, and Question #21 from November 1988 develop essentially the same irrelevant point.

Question #23 from November 1990 and Question #5 from May 1991 are based on the unrealistic point that a party who has entered a contract because of duress may avoid the obligation and the contract may be voidable. The aforementioned Question #23 is set forth for reference.

23. A purchaser of land to avoid a contract with the seller based on duress, it must be shown that the seller's improper threats:

a. constituted a crime or tort.
b. would have induced a reasonably prudent person to assent to the contract.
c. actually induced the purchaser to assent to the contract.
d. were made with the intent to influence the purchaser.
The point of criticism once again focuses on the lack of relevancy of the subject matter of the questions. As a practical matter, a negligible amount of contracts are based on force, fear, or threats. Therefore, there is little reason to test candidates on this subject.

Question #16 from the May 1990 and Question #23 from the May 1992 examinations develop the rather esoteric point that a pledge to a charitable organization which is relied upon by the organization in incurring large expenditures may be enforceable against the promisor despite the fact that the promise is not supported by consideration. Question #23 follows.

23. Which of the following will be legally binding despite lack of consideration?

a. An employer's promise to make a cash payment to a deceased employee's family in recognition of the employee's many years of service.

b. A promise to donate money to a charity on which the charity relied in incurring large expenditures.

c. A modification of a signed contract to purchase a parcel of land.

d. A merchant's oral promise to keep an offer open for 60 days.

While the point of law may be accurate, as a practical matter charitable organizations do not as a general rule sue those who fail to honor promises to contribute. The loss of goodwill would generally outweigh the monetary gain received from the enforced promise. Additionally, there is small likelihood that businesses will make pledges of such size as to jeopardize seriously their positions. On the issue of relevancy, therefore, there is little.

Another unrealistic background for a question presented by the examiners is one in which a corporation, not an individual, files a voluntary petition in bankruptcy. An individual may receive a discharge of debts in bankruptcy, but a corporation's debts are not dischargeable in a Chapter 7 proceeding. Therefore, corporations as a general rule do not voluntarily seek to liquidate. Nevertheless, Questions #33 and #42 from May 1991 and November 1991, respectively, use corporations filing voluntary petitions as the framework for the questions.

Question #18 from November 1988, set forth below, involves the ramifications of failing to give notice of assignment to an obligor when a claim has been assigned. Question #23 of May 1988 is similar.

18. Pix borrowed $80,000 from Null Bank. Pix gave Null a promissory note and mortgage. Subsequently, Null assigned the note and mortgage to Reed. Reed failed to record the assignment or notify Pix of the assignment. If Pix pays Null pursuant to the note, Pix will:

a. be primarily liable to Reed for the payments made to Null.

b. be secondarily liable to Reed for the payments made to Null.

c. not be liable to Reed for the payments made to Null because Reed failed to record the assignment.

d. not be liable to Reed for the payments made to Null because Reed failed to give Pix notice of the assignment.

While choice "d" is clearly the best choice for Question #23, another question might be whether this is an important point on which to test candidates. It is routine business practice for those contemplating the purchase of an assignment to notify the obligor. Indeed, the prospective assignee is frequently in contact with the obligor before the claim is purchased in order to ascertain the status of the account or claim. It is extremely uncommon for those involved in business transactions to purchase a claim without contacting the obligor.

Question #55 from May 1990 deals with the various types of recording statutes for interests in real property. In order to answer properly this question set forth below, the candidate must be familiar with not only the types of recording statutes generally in use, but must also be knowledgeable concerning the "race" recording type statute which is virtually non-existent in the United States. This question calls for knowledge of more than the general rule of recording. Under this type statute, the first party to record is deemed to have the greatest rights regardless of the good faith or lack of good faith of the recording party.

55. On February 2, Mazo deeded a warehouse to Parko for $450,000. Parko did not record the deed. On February 12, Mazo deeded the same warehouse to Nexis for $430,000. Nexis was aware of the prior conveyance to Parko. Nexis recorded its deed before Parko recorded. Who would prevail under the following recording statutes?
The November 1993 examination contained two questions on securities regulations which focus on issues which are remote or irrelevant to the practice of CPAs. The regulation of the sale of securities is a test area where the examiners formerly seemed to have little difficulty in framing appropriate questions.

Question #4 set forth below is based on this narrative provided to the students:

While conducting an audit, Larson Associates, CPAs, failed to detect material misstatements included in its client's financial statements. Larson's unqualified opinion was included with the financial statements in a registration statement and prospectus for a public offering of securities made by the client. Larson knew that its opinion and the financial statements would be used for this purpose.

4. In a suit by a purchaser against Larson for common law negligence, Larson's best defense would be that the:

   a. audit was conducted in accordance with generally accepted auditing standards.
   b. client was aware of the misstatements.
   c. purchaser was not in privity of contract with Larson.
   d. identity of the purchaser was not known to Larson at the time of the audit.

The best answer to Question #4 is clearly "a." However, a purchaser of an original issue of securities in which there was a material misstatement would not sue for common law negligence. The purchaser would enforce the rights provided by the Securities Act of 1933 which provides that there is liability for any materially false, misleading or omitted information in the registration statement or prospectus. Under the statute, there is no need for the plaintiff to establish that the defendant was negligent. Accordingly, the issue raised by the question, liability for negligence, is irrelevant.

Question #6 from November 1993 deals with an issue of an accountant providing an unqualified opinion on financial statements although material misstatements were discovered. The question then explains that the financial statements were included in a registration statement and prospectus and then raises an issue of fraud under Section 10(b) of the Securities Exchange Act of 1934. While it may be important for accountants to understand Section 10(b), it seems that the question should have a more appropriate focus. As indicated above, a purchaser of an original issue of securities, the situation presented in this question, would in all probability simply enforce its rights under the 1933 Act. Why would the plaintiff undertake the difficult role of proving fraud when this is unnecessary for recovery?

Conclusion

Within the parameters established by the AICPA, the examiners have done a reasonably good job in creating the multiple choice portion of the Uniform CPA Business Law examinations for the years 1988-1992. Recalling former examinations and discussing with candidates who have taken those examinations, the tendency is to focus on the less appropriate questions. But closer observation reveals that with few exceptions the questions fall within the content specification guidelines provided to candidates. The questions in general are clear with only one correct answer.

The area in most need of improvement concerns the relevancy of the questions to the realities of the business world.

Questions which have little or no relevancy to the actual accounting practice of CPAs help to certify candidates who should be tested on more relevant topics. There is also an indirect negative effect of these poor questions. Many faculty prepare students to pass the CPA examination. This is done in classes specifically designed to accomplish this and also in classes where it is simply assumed that the business law/legal environment course will provide useful information for passing the exam. Faculty are aware of the content of the examination and many will necessarily address topics presented on that examination. Topics which have little application to real life situations end up receiving valuable class time and attention thereby compounding the problem.
The examination assesses the right of a candidate to a license. "Authentic assessment should engage students in meaningful material and in problem solving." We have noted several problem areas where the material is not especially meaningful. Eliminating questions on these topics and replacing them with more topical questions would improve the examination. Perhaps a survey of businesspersons and CPAs to ascertain matters of concern in their experiences might be the source of worthwhile questions.

In addition, analysis of the twelve examinations from 1988-1993 shows a great deal of repetition in the content and the framework of the questions. Inasmuch as the examiners appear to have difficulty creating fresh and challenging questions, it would seem that this problem would be compounded by the examiners’ move to an all-objective examination. The wisdom of that approach should be reviewed.

ENDNOTES

1 15 USC Sec. 11.
3 Id at 47-50.
4 Id at 6.