

EXERCISING PROFESSIONAL JUDGMENT

Should a CPA be subject to State sanction for exercising professional judgment?

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The Board's Authority to Discipline Licensees

On a determination that **a ground for discipline exists under Section 901.502**, after notice and hearing as provided by Section 901.509, the board may:

- (1) revoke a certificate, firm license, or practice privilege issued under this chapter;
- (2) suspend under any terms a certificate, firm license, practice privilege, or license issued under this chapter for a period not to exceed five years;
- (3) refuse to renew a license;
- (4) place a license holder on probation;
- (5) reprimand a license holder;
- (6) limit the scope of a license holder's practice;
- (7) require a license holder to complete a peer review program conducted in the manner prescribed by the board;
- (8) require a license holder to complete a continuing education program specified by the board;
- (9) impose on a license holder the direct administrative costs incurred by the board in taking action under Subdivisions (1) through (8);
- (10) require a license holder to pay restitution as provided by Section 901.6015;
- (11) impose an administrative penalty under Subchapter L; [FN1] or
- (12) impose any combination of the sanctions provided by this subsection.

Statutory Grounds to Discipline Licensees

- The board may discipline a person under Section 901.501 for:
 - (1) fraud or deceit in obtaining a certificate, firm license, or license under this chapter;
 - (2) **FRAUD, DISHONESTY, OR GROSS NEGLIGENCE** in the performance of services as a license holder, including:
 - (A) knowingly participating in the preparation of a false or misleading financial statement or tax return; or
 - (B) failing to file the license holder's own income tax return;
 - (3) the failure of a person who is certified or required to hold a firm license under this chapter to obtain a license not later than the third anniversary of the date on which the person was certified or required to obtain a firm license;
 - (4) the failure of a person who is licensed under this chapter to renew the license not later than the third anniversary of the date on which the person most recently obtained or renewed the license;

Statutory Grounds to Discipline Licensees

- The board may discipline a person under Section 901.501 for:
 - (5) a violation of Subchapter J;
 - (6) a violation of a rule of professional conduct adopted by the board;**
 - (7) a revocation or suspension of the certificate or firm license or a revocation, suspension, or refusal to renew the license of the person's partner, member, or shareholder;
 - (8) a revocation, cancellation, placement on probation, limitation on the scope of practice, or suspension by another state, or a refusal of renewal by another state, of the authority issued by that state to the person, or to the person's partner, member, or shareholder, to engage in the practice of public accountancy for a reason other than the failure to pay the appropriate authorization fee;
 - (9) a revocation or suspension of, or a voluntary consent decree concerning, the right of the person, or of the person's partner, member, or shareholder, to practice before a state or federal agency for a reason the board determines warrants its action;

Statutory Grounds to Discipline Licensees

- The board may discipline a person under Section 901.501 for:

(9) a revocation or suspension of, or a voluntary consent decree concerning, the right of the person, or of the person's partner, member, or shareholder, to practice before a state or federal agency for a reason the board determines warrants its action;

(10) a final conviction of or the imposition of deferred adjudication for an offense under the laws of any state or the United States that:

(A) is a felony; or

(B) includes fraud or dishonesty as an element of the offense;

(11) conduct indicating lack of fitness to serve the public as a professional accountant; or

(12) a violation by a license holder or an owner of a certified public accountancy firm who is not a license holder of:

(A) this chapter;

(B) professional standards adopted by the board; or

(C) a rule or order adopted by the board

Auditing Standards as a basis for discipline

A person shall not permit his name to be associated with financial statements in such a manner as to imply that he is acting as an auditor with respect to such financial statements, **unless he has complied with applicable generally accepted auditing standards.**

Statements on auditing standards issued by the American Institute of Certified Public Accountants, auditing standards included in Standards for Audit of Government Organizations, Programs, Activities and Functions issued by the United States General Accounting Office, Public Company Accounting Oversight Board, and in other pronouncements having similar generally recognized authority, are considered to be **interpretations** of generally accepted auditing standards, and departures from such pronouncements must be justified

Accounting Principles as a basis for discipline

A person or person practicing under a practice privilege as provided for in § 901.462 of the Act, shall not issue a report asserting that financial statements are **presented in conformity with generally accepted accounting principles** if such financial statements contain **any departure** from such accounting principles which has a material effect on the financial statements taken as a whole, **unless** the person or person practicing under a practice privilege as provided for in § 901.462 of the Act can demonstrate that by reason of **unusual circumstances** the financial statement(s) would otherwise have been misleading.

The report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the generally accepted accounting principles would result in a misleading statement. For purposes of this section, **generally accepted accounting principles are considered to be defined by pronouncements issued by the Financial Accounting Standards Board and its predecessor entities and similar pronouncements issued by other entities having similar generally recognized authority.**

Other Professional Standards as a Basis for Discipline

A person in the performance of consulting services, accounting and review services, any other attest service, or tax services shall conform to the professional standards applicable to such services. For purposes of this section, such professional standards are considered to be interpreted by:

- (1) Statements on Standards on Consulting Services (SSCS) issued by the American Institute of Certified Public Accountants;
- (2) Statements on Standards for Accounting and Review Services (SSARS) issued by the American Institute of Certified Public Accountants;
- (3) Statements on Standards for Attestation Engagements (SSAE) issued by the American Institute of Certified Public Accountants;
- (4) Statements on Standards for Tax Services issued by the American Institute of Certified Public Accountants; or
- (5) similar pronouncements by other entities having similar national or international authority.

The TSBPA v. Licensees

The TSBPA alleges that the licensee's audit work "failed to comply with Generally Accepted Auditing Standards." That he:

failed to properly address and/or analyze in his audit two issues involving the client's financial condition that were critical and material to both the USDA and the client itself: the accounts receivable and the "going concern" issues.

That his audit work as described above constitutes violations of sections Secs. 901.502(12)(B), 901.502(6) and T.A.C. 501.60

The Licensee's Contention

1. The Board of Public Accountancy lacks the statutory authority to discipline an accountant for good faith performance of services as a license holder without proving that the accountant committed fraud, dishonesty, or gross negligence; and *[i.e. that the Board lacks the authority to discipline licensees for actions that are less than fraudulent, dishonest, or grossly negligent.]*
2. The Due Process Clause of the United States Constitution prohibits the Board from imposing discipline on an accountant for violations of GAAS or GAAP without proving that the accountant acted or failed to act with a culpable mental state. *[i.e. that the board should be required to establish that a licensee acted "willfully" or with a degree of knowledge that makes the person responsible for the consequences of his or act or omission.]*

The Audit

- 2006 engagement: cost allocation evaluation
 - Verification of client expenses, payroll, time records to determine reimbursement by USDA
 - The Licensee’s expert testified that the “level of verification exceeded the minimum required.”
 - The Board contends that his “work papers” were inadequate.
 - What is “enough” documentation?

The Lawyer's Explanation

Essential questions arise:

- What is “enough” documentation?
- What are “work papers”?
- Is ordinary negligence sufficient to trigger board sanctions?
- Expert v. Expert; who do you believe?
- The Board's role in reviewing audits?
- The role of peer review?

Who decides proper application of GAAP?

- TSBPA
- Peer review
- AICPA
- Client
- CPA

Who decides proper application of GAAP?

TSBPA

- The board shall (1) administer this chapter; (2) adopt rules the board determines are necessary or advisable to administer this chapter; (3) keep a record of each proceeding conducted before or action taken by the board; and (4) keep an official seal.
- The board may initiate . . . disciplinary proceedings.

Tex. Occ. Code 901.151

Who decides proper application of GAAP?

Peer Review

The board by rule shall provide for a peer review program to review the work product of a license holder or of the certified public accountancy firm in which the license holder is a member, in lieu of the license holder, to the extent necessary to comply with any applicable standards adopted by generally recognized bodies responsible for setting accounting standards. Peer review must include a verification that each individual in a certified public accountancy firm who is responsible for supervising attest services and who signs or authorizes another person to sign an accountant's reports on financial statements on behalf of the firm meets the competency requirements of the professional standards that apply to those services.

Tex. Occ. Code 901.159

Who decides proper application of GAAP?

Texas Peer Review

Pursuant to § 901.159 of the Act, the board establishes a peer review program to monitor CPAs' compliance with applicable accounting, auditing and other attestation standards adopted by generally recognized standard-setting bodies. The program may include education, remediation, disciplinary sanctions or other corrective action where reporting does not comply with professional or regulatory standards.

22 T.A.C. 527.1

Who decides proper application of GAAP?

AICPA Peer Review

The AICPA practice monitoring program is dedicated to continually enhancing the quality of accounting, auditing, and attestation services performed by AICPA members in public practice. To protect the public interest, **the program is driven by adherence to the highest possible professional standards** and understanding the changing business and regulatory environments. The AICPA practice monitoring program enables firms to meet their state licensing, federal regulatory and/or AICPA membership requirements.

AICPA



Who decides proper application of GAAP?

Client

The civil courts remain available to clients who are dissatisfied with how a CPA may have prepared their accounting records.

A client may complain to the TSBPA for claims of “fraud, dishonesty, or gross negligence.” Tex. Occ. Code 901.502

Legal Standards

- Is the rule arbitrary or capricious?
- A regulation that is incomplete, vague, indefinite, and uncertain, and forbids an act that is so vague that people of common intelligence must necessarily guess at its meaning and differ as to its application violates the requirements of due process.
- Are GAAS written in a fashion that mandates action on the part of a licensee? No. They are instructive but not declaratory.

Lone Star Gas Co. v. Kelly, 165 S.W.2d 446 (1942)

Connally v. Gen. Constr. Co., 269 U.S. 385 (1926)

Words have meaning

- What does “old” mean?
- What does “due care” mean?
- What does “sufficient” or “enough” mean as applied to documentation?
- What are “work papers”?
- GAAS are rife with instructions that an auditor “should” perform certain actions; but “should” does not mean “must.”

Lone Star Gas Co. v. Kelly, 165 S.W.2d 446 (1942)

Connally v. Gen. Constr. Co., 269 U.S. 385 (1926)

Supreme Court Determination

- Does the regulation threaten to inhibit the exercise of a constitutionally protected right? *No. There is no contention that the Board is attempting to inhibit a protected right.*
- With regard to a business regulation, the principal inquiry is whether the law affords “fair warning” of what is proscribed. *The principal contention is that the rules, as written, do not provide “fair warning” of proscribed actions.*

Vill. of Hoffman Estates v. The Flipside, Hoffman Estates, Inc., 455 U.S. 489 (1982)

Does GAAP/GASS advise you of what is proscribed?

Even the Supreme Court has acknowledged that GAAP is not a clear set of instructions.

- Financial accounting is not a science. It addresses many questions as to which the answers are uncertain and is a "process [that] involves continuous judgments and estimates."
- GAAP is not the lucid or encyclopedic set of pre-existing rules that the dissent might perceive it to be. Far from a single-source accounting rulebook, GAAP "encompasses the conventions, rules, and procedures that define accepted accounting practice at a particular point in time."
- GAAP changes and, even at any one point, is often indeterminate. "The determination that a particular accounting principle is generally accepted may be difficult because no single source exists for all principles."

Shalala v. Guernsey Mem'l. Hosp., 514 U.S. 1987 (1995)

GAAS anticipates the use of professional judgment

- In the observance of generally accepted auditing standards, the independent auditor **must exercise his judgment** in determining which auditing procedures are necessary in the circumstances to afford a reasonable basis for his opinion. His judgment is required to be the informed judgment of a qualified professional person. **AICPA AU 110.05**
- The auditor must exercise **due professional care** in the performance of the audit and the preparation of the report. **AICPA AU 230.01.**
- This standard requires the independent auditor to plan and perform his or her work with **due professional care**. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting. **AICPA AU 230.02.**

GAAS expects that differences of opinion will arise.

Cooley on Torts, a legal treatise, describes the obligation for due care as follows:

Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with **reasonable care and diligence**. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. **But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.** AICPA AU 230.03

GAAP anticipates the use of professional judgment.

The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles. **AICPA AU 410.01**

The term *generally accepted accounting principles* as used in reporting standards is construed to include not only accounting principles and practices but also the methods of applying them. The first reporting standard is construed not to require a statement of fact by the auditor but an opinion as to whether the financial statements are presented in conformity with such principles. If limitations on the scope of the audit make it impossible for the auditor to form an opinion as to such conformity, appropriate qualification of his report is required. **AICPA AU 410.02**

GAAS standards applicable to going concern conclusions require professional judgment.

This section provides guidance to the auditor in conducting an audit of financial statements in accordance with generally accepted auditing standards with respect to evaluating whether there is **substantial doubt** about the entity's ability to continue as a going concern. **Continuation of an entity as a going concern is assumed** in financial reporting in the absence of significant information to the contrary. Ordinarily, information that **significantly contradicts** the going concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions. **AICPA AU 341.01.**

The auditor has a responsibility to evaluate whether there is **substantial doubt** about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited (hereinafter referred to as *a reasonable period of time*). **AICPA AU 341.02**

Confirmation standards are not declaratory.

Confirmation is the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular items affecting financial statement assertions. The process includes . . . **AICPA AU 330.04**

The auditor **should** assess whether the evidence provided by confirmations reduces audit risk for the related assertions to an acceptably low level. In making that assessment, the auditor **should** consider the materiality of the account balance and his or her inherent and control risk assessments. When the auditor concludes that evidence provided by confirmations alone is not sufficient, additional procedures **should** be performed. For example, to achieve an appropriately low level of audit risk related to the completeness and existence assertions for accounts receivable, an auditor may perform sales cutoff tests in addition to confirming accounts receivable. **AICPA AU 330.09**

The licensee's product is an opinion.

The auditor's opinion that financial statements present fairly an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles should be based on his or her judgment as to whether (a) the accounting principles selected and applied have general acceptance; (b) the accounting principles are appropriate in the circumstances; (c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation (see section 431); (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed (see section 431); and (e) the financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements. **AICPA AU 411.04**

GAAP is not a single source of information.

Independent auditors agree on the existence of a body of generally accepted accounting principles, and they are knowledgeable about these principles and in the determination of their general acceptance. Nevertheless, the determination that a particular accounting principle is generally accepted may be difficult because no single reference source exists for all such principles. AICPA AU 411.05

Neither GAAP nor GAAS were written as statutory declarations.

- Statutes are typically written as declarations of proscribed activities, e.g. prohibitions against murder or theft.
- Quasi-criminal sanctions such as the imposition of fines or the revocation of licenses should not be based on differences of opinion.
- Peer-review is the process by which the legislature and the AICPA anticipated licensees' ordinary compliance with GAAP/GAAS would be regulated.
- Licensees should be permitted to exercise professional judgment without fear that a licensing authority may second-guess their opinion and impose sanctions should it come to a different conclusion.
- Without any requirement that the Board establish the licensee to have acted "fraudulently," "dishonestly," or with "gross negligence," the Board may act arbitrarily to sanction licensees with whom it disagrees.

Why should I care?

The practice of public accountancy is a learned profession. CPA/auditors are called upon to express opinions. Exercising professional judgment, a learned professional may reach a conclusion different from that of others who examine the same information. CPAs should be able to utilize their “good faith” professional judgment without fear the Board may impose a sanction because its hired professional reaches a different conclusion. This is why the Texas Association of CPAs should and does care about this matter.



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Call us. Fax us. E-mail us.

We help CPAs with representation issues
before the State Board of Accountancy.