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INVESTOR VIEWS OF AUDIT ASSURANCE: RECENT EVIDENCE OF THE EXPECTATION GAP

What do investors expect from an audit?

by Marc J. Epstein and Marshall A. Geiger

Investors and financial statement users long have agreed on the usefulness of the audit in financial reporting. Over time, however, auditors have been expected to provide assurance in varying degrees and for different purposes. Differences in perception—especially regarding assurances provided—between users, preparers and auditors have been termed the "expectation gap." This article provides some startling evidence of the existence of such a gap in investor perceptions of the assurance provided by an audit.

EVOLUTION OF THE AUDIT

In the early years of the U.S. auditing profession—from 1850 to the early 1900s—auditors primarily were engaged to provide almost absolute assurance against fraud and intentional mismanagement. As corporate America grew and the auditing profession developed, the early 1900s saw a shift away from verifying all transactions and amounts for purposes of fraud detection to determining fairness in financial statement reporting. This shift partly was a response to the burgeoning volume of business activity (making fraud detection less feasible) and the appearance and increased importance of a new business player—the shareholder. Corporate shareholders and other outside parties became increasingly reliant on auditors to attest to management-provided information, necessitating a shift in the primary audit objective to providing assurance on externally reported financial information.

Current practice has not strayed far from that of early corporate America, with the primary audit focus on financial statement reasonableness. Current standards still reflect the material misstatement focus and increasingly have relied on the concept of "reasonable assurance" in depicting the level of reliance to be placed on audited information. One need only skim current auditing standards to find pervasive evidence of the reasonable assurance concept's use as the foundation for reliance on audited financial statements. Statement on Auditing Standards no. 31, *Evidential Matter*, SAS no. 39, *Audit Sampling*, and SAS no. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregu-*

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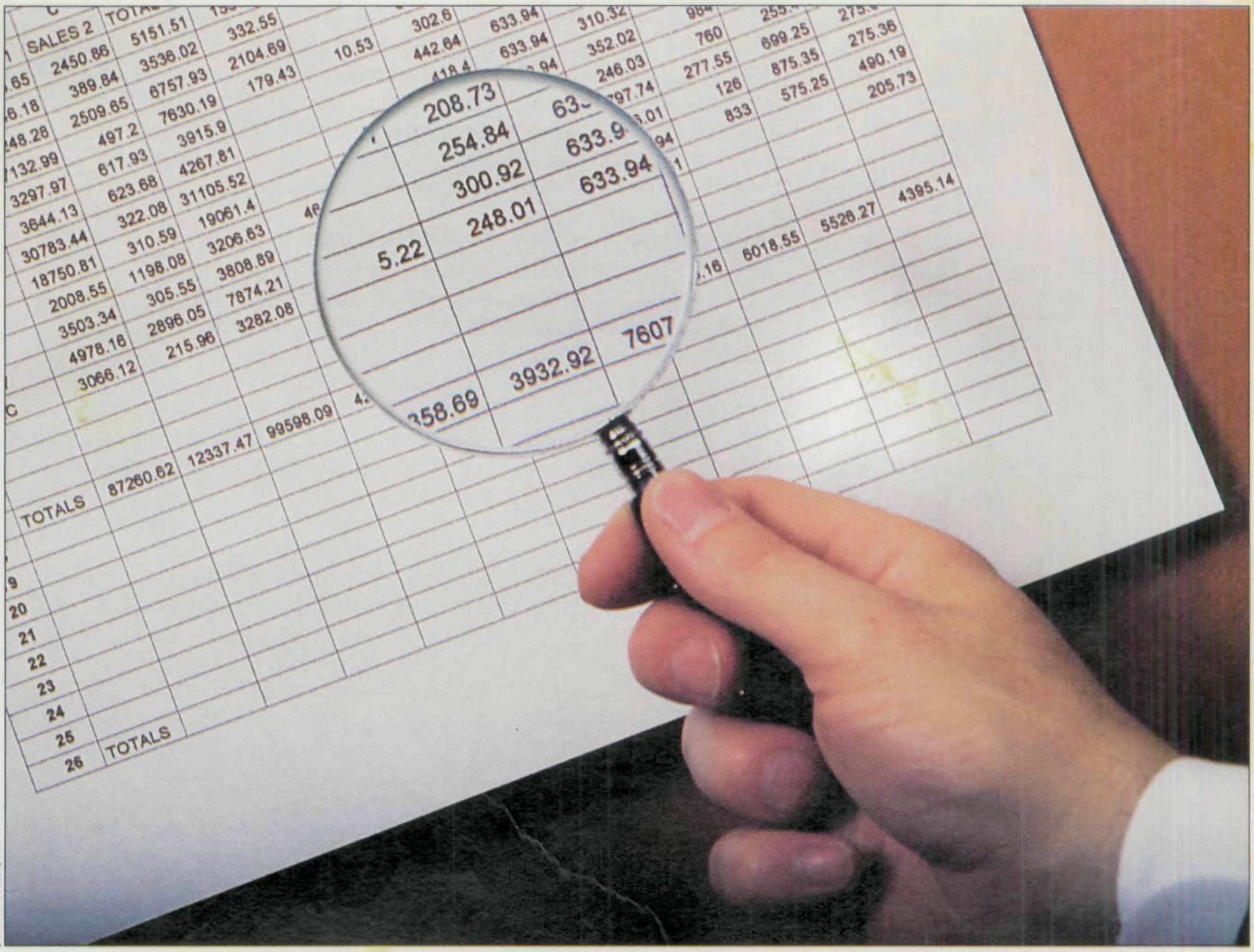

JOS. PALMIERI/AFI

larities, all rely on the concept of reasonable assurance.

Regardless of professional standards, however, an important question for the profession is, What assurance does the public currently expect auditors to provide? As a profession, CPAs continually must assess public reaction to their stated role in financial reporting as well as determine the public's perception of the type and level of assurances believed or desired to be provided by auditors.

THE ASSURANCE PROBLEM

The expectation gap has plagued the public accounting profession almost from inception. Yet the profession has tried to minimize the disparity. From 1945 to 1950, the American Institute of Accountants (an American Institute of CPAs predecessor) undertook an active campaign to enlighten the public to the public accountant's "true" responsibility. Around this time, the profession began to clarify communications to the public regarding its self-perceived responsibility. Specifically, the standard auditor's report was modified in 1948 to communicate better to the public what an audit was and to present the auditor's opinion more clearly. In 1950, over 70,000 copies of a pamphlet describing an audit, audit reports and auditor responsibilities were distributed to banks and other groups interested or involved in financial reporting.

These early efforts were the profession's attempts to bring public perception in line with the profession's notion of its role. Recent efforts have focused on both public opinion and changing professional standards to bridge the gap.

THE NEW SASs

A battery of expectation gap SASs were issued in 1988 partly to address public criticism of the auditing profession and partly to provide increased levels of service to audit clients and the public. Although several of the SASs depict auditor responsibility in terms of the reasonable assurance concept, two are especially germane. SAS no. 58, *Reports on Audited Financial Statements*, requires a new standard audit report including an explicit statement that an audit provides reasonable assurance for reliance on the fairness of the financial statements. SAS no. 53 increases the auditor's responsibility to design an audit to provide reasonable assurance that material errors and irregularities will be detected.

The statement added to the new audit report is a culmination of almost 20 years of effort to establish reasonable assurance as a basis for the standard report. In 1972, the AICPA committee on auditing procedure proposed a modified audit report to address what its members believed were differences in intended and perceived audit report messages. The proposed report included the notions of materiality, testing and reasonable assurance, but it eventually was withdrawn due to anticipated negative public reaction. Several intermittent attempts to alter the standard audit report also tried to include reasonable assurance in a new report. SAS no. 58 embodies the intent of these early proposals with an explicit reference that communicates to readers that an audit provides reasonable assurance of financial statements' material accuracy.

While SAS no. 58 communicates more explicitly the level of assurance an audit is intended to provide, SAS no. 53 says auditors have a responsibility to design audits to provide reasonable assurance that all material misstatements will be detected. Former standards had required auditors to plan an audit to search for material errors and irregularities. Together, these SASs reinforce both internally and externally the concept of reasonable assurance and the intention that an audit provide such a level of assurance to users.

SHAREHOLDER VIEWS

We recently conducted a national survey of investors to gather information on their views of various aspects of financial reporting issues. Participants were selected if they owned 100 or more shares of a stock listed on the American or New York stock exchanges. In total 246 responses were obtained, representing individuals from all 50 states.

Two separate questions asked investors what level of assurance they believed auditors should provide for detecting material misstatements as a result of error (unintentional misstatements) and as a result of fraud (intentional misstatements). The anticipated typical response was reasonable assurance. However, investors held auditors to a much higher level of assurance. The exhibit on page 64 gives the results of both questions.

For material misstatement due to errors, only about 51% of the investors believed they should receive reasonable assurance. Approximately 47% wanted absolute assurance financial statements are free of material misstatements due to errors. This unexpected result clearly is in

EXECUTIVE SUMMARY

■ FOR MANY YEARS A GAP HAS existed between the assurances auditors provide on management-compiled financial information and the expectations of investors and other financial statement users.

■ RECENT EFFORTS TO CLOSE the expectation gap have focused on influencing public opinion and changing professional standards to ensure an audit is designed to provide reasonable assurance that material errors, irregularities and misstatements in financial statements will be detected.

■ A SURVEY OF INVESTORS found they held auditors to a high level of assurance. Almost half expected complete or absolute assurance that material financial statement errors would be detected. Over 70% expected absolute assurance that material misstatement due to fraud would be detected.

■ IF INVESTORS EXPECT AND the courts begin to uphold a standard of absolute assurance, audit liability inevitably will increase. As a result, the profession should devote substantial resources to increasing public understanding of an audit's nature and its inherent limitations.

■ WHILE A VARIETY OF MEANS are available for bridging the expectation gap, including increased public awareness and education, the most immediate is through adherence to current audit standards. Auditors should be more sensitive to the possible existence of fraud in every audit they conduct.

Investor perceptions of audit assurance

The auditor should do whatever investigation is necessary so he or she can provide assurance the audited financial statements are free from material misstatements. This assurance should be described as follows:

	Error	Fraud
No assurance necessary	1.67%	2.51%
Reasonable assurance	51.05	26.36
Absolute assurance	47.28	71.13

opposition to the levels of assurance stated in the auditor's report and in current professional standards.

As surprising as these results are, they pale in comparison with the high assurance levels sought for fraud detection. Over 70% of investors believe auditors should be held to absolute assurance for detecting material misstatement due to fraud. The profession, in SAS no. 53, formally recognizes that frauds and intentional misrepresentations, even if material, are more difficult to detect than misstatements due to errors.

Nevertheless, investors seemingly set the assurance standard for detection of fraud higher than that for detection of errors—both of which exceed current professional standards. Hence, the profession's perception that an audit should provide reasonable assurance of financial statement accuracy is held by only a minority of investors. In sum, the majority of investors want from an audit absolute assurance the financial statements are free of all types of material misstatement.

BRIDGING THE GAP

The findings unmistakably reveal an expectation gap between auditors and investors on the level of assurance an audit provides. The evidence suggests investors seek very high levels of financial statement assurance. Auditors should not only be interested in but also be aware of these shareholder perceptions. The litigious environment in which CPAs operate mandates that we, individually and as a profession, monitor public opinion and attitudes toward the level of services and assurance provided.

If investors expect, and courts begin to uphold, a standard of absolute assurance, audit liability inevitably will increase substantially. Thus, it is necessary from both societal and professional perspectives that CPAs try to narrow the expectation gap. To do so, however, both groups need to become active agents for change.

The gap may be narrowed partly through increased public understanding of an audit's nature and its inherent limitations. The AICPA should devote substantial resources to explaining to the public the auditor's current role in the financial reporting process and an audit's inevitable limitations. Increased educational efforts with clients and audit committees, at shareholder meetings, in professional and civic organizations and at every available juncture should be used to communicate an audit's merits and limitations. Our survey found that, in general, the more educated an investor was regarding accounting, finance and investment analysis—including the use of the auditor's report—the less likely he or she was to require absolute auditor assurance. Hence, increased awareness and education seem to be viable ways to bridge the gap.

Accordingly, an additional way of educating the public is through continued use of the new audit report explicitly indicating reasonable assurance. Since the report has been used for a relatively short period of time, it may take longer for the new messages to affect public perception sufficiently. Standard setters should continuously evaluate the audit report's communicative effectiveness by testing wording changes on investors, bankers, educators, government and court officials to learn how the audit report affects perceptions of the assurances provided and not provided by an audit. However, reliance on the audit report alone to educate report users will not be sufficient to have an impact on user perceptions.

A supplemental educational medium that may be used is the 1989 AICPA pamphlet, *Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users.* Unfortunately, the pamphlet has not attained widespread distribution and, accordingly, its educational impact has been minimal. Substantially increased dissemination would be advantageous in presenting auditor views and providing a foundation for discussion that eventually might lead to a narrowing of the gap. But individual shareholders are not likely to read this publication unsolicited.

A more direct approach to increasing

user awareness of the audit function was suggested by Robert Mednick. (See "The Auditor's Role in Society: A New Approach to Solving the Perception Gap," JofA, Feb.86, page 70.) He proposed a supplemental "report" to accompany the audit report describing in plain English an audit's usefulness, the assurances provided and the limitations. Such a report essentially would summarize the information in the AICPA pamphlet but would be substantially condensed and much more visible and useful to all financial information users.

Since messages of this type, no matter how positively worded, could become tainted if promulgated by the AICPA, the Securities and Exchange Commission should be encouraged to develop a similar unbiased report to be presented with registrants' filings and financial statements. An SEC communication regarding the audit function and the assurances provided may be more convincing to financial statement users than one emanating from auditors. A SEC requirement, however, will not be effective for smaller and nonpublicly traded entities.

The profession lacks an easily accessible fraud database. Development and dissemination of a national database on perpetrated frauds and the effective and efficient methods of detecting various frauds would increase audit effectiveness. Since financial statement users seek high levels of assurance, fraud-detection techniques and their appropriate use should be readily available to all auditors. If they were, fraud audits might become more prevalent or even routine as part of the service package offered by auditors.

The audit risk model in SAS no. 47, *Audit Risk and Materiality in Conducting an Audit,* suggests overall audit risk (in terms of the overall level of assurance provided by an audit) can be reduced through increased substantive testing. Another way to address the gap is to offer a range of audit services (including fraud audits) with various levels of assurance. During the shareholders' meeting, investors could be offered an array of applicable services and approximate costs. They then could decide for themselves what level of assurance they are willing to pay for each year. This would serve not only to educate investors to an audit's inherent limitations but also to enlighten them to the relative costs for increased audit work that would lead to increased levels of assurance.

The most immediate means of bridging the gap is simply through adherence to current audit standards. The important message behind SAS no. 53 is auditors should be more sensitive to the possible existence of material irregularities (frauds) in every audit. Heightened audit sensitivity to management honesty and integrity not only will affect overall audit performance but also will produce audits that provide the highest levels of assurance currently possible for the detection of all misstatements.

In the long term, to move toward bridging the expectation gap the audit profession needs to expand services and undergo a fundamental change in attitude from self-defense-self-preservation to meeting society's expectations. This shift is beginning to take place already. Such a reorientation also means an expansion of services, including more work to detect frauds and more internal control audits and disclosures. It also means more opportunities to

- Increase the quality and diversity of audits.
- Increase the scope of services provided and, accordingly, firm revenues.
- Decrease liability exposure due to not meeting existing user demands.

To close the gap more completely, however, the audit profession and financial community need to reexamine the fundamental role of an audit in society and to be sure financial statement preparers, users and auditors all are in agreement. As long as users and auditors continue to have different understandings of what "present fairly" according to generally accepted accounting principles really means, the expectation gap will remain and auditors will continue to be faced with lawsuits.

HARD TO IMPLEMENT

Some of these suggestions may be hard to implement. However, until substantial changes occur the expectation gap will persist and the litigation explosion will continue to plague CPAs as injured shareholders argue accountants "should have known" a stock's price was going to fall or a fraud had been committed.

Investor views should serve as a reminder to the profession and individual auditors that professional audit standards do not dictate public opinion. Misconceptions and differences in expectations—not to mention the current litigious environment—will persist unless effectively and timely addressed. ■

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