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The New Auditor's Report: Have the Benefits of Wording Changes Been Acknowledged Outside the CPA Profession?

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THE NEW AUDITOR'S REPORT

Have the benefits of wording changes been acknowledged outside the CPA profession?

by Marshall A. Geiger

CPAs use the auditor's report to communicate their opinions of an entity's financial statements and related disclosures. Concerned parties, in turn, use the report to assess the integrity of the financial statements and the accuracy of the disclosures.

In 1988, the American Institute of CPAs auditing standards board established new wording for the standard unqualified audit report. It also revised the reporting requirements and types of audit reports allowed (for example, the *subject-to* report for uncertainties and *except-for* report for consistency departures were eliminated). The new wording appears in Statement on Auditing Standards no. 58, *Reports on Audited Financial Statements.* (The sidebar on page 61 describes the evolution of the audit report until SAS no. 58's issuance.)

With these audit reporting changes and modifications comes the need for CPAs to assess how financial statement users perceive the new reports and what impact the wording has had. One question is how users who continually encounter different types of reports are affected. Have these changes been acknowledged by those outside the CPA profession? If so, have they been beneficial?

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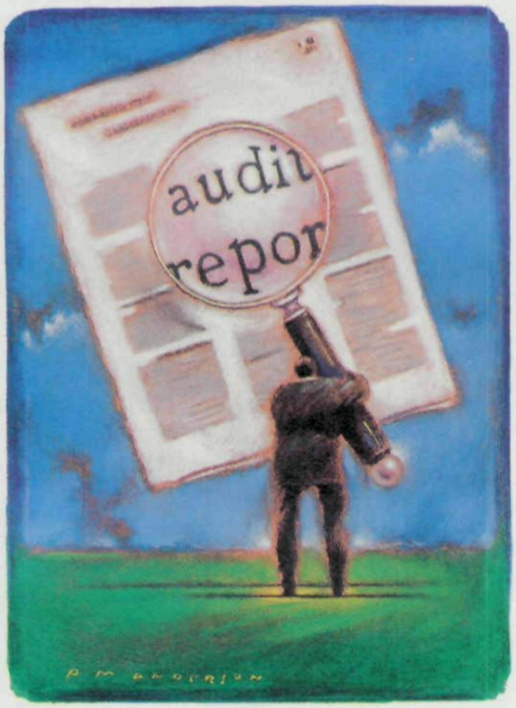

PAUL ANDERSON

This article reports on a study of bank loan officers conducted to determine how this group of users perceived some of the new audit reports compared with former reports. The loan officers generally viewed the new standard report similarly to the old one. However, they liked the new modified unqualified consistency report better than both the former except-for consistency report and the standard unqualified report used alone in the event of an accounting change.

GAUGING USER PERCEPTIONS

One hundred seventy-eight bankers participated in the survey to assess the impact of the new standard unqualified report and the new modified unqualified consistency report on their perceptions of an audit, the auditor and the audit report. It was conducted in the fourth quarter of 1989 to determine users' initial reactions to the new reports (SAS no. 58 is effective for all reports issued or reissued after January 1, 1989). Bank loan officers were chosen for the survey because of their constant exposure to various audit report types and their familiarity with the meaning intended to be communicated through such reports—new or old.

Participants reviewed a loan application for a medium-sized regional retail grocery company (with $51 million in sales) operating at or slightly below industry averages. A marginal applicant was used to allow the audit report wording a greater opportunity to affect the bankers' perceptions. The loan request was for $2.2 million, repayable in equal quarterly installments over 10 years. The proceeds were to be used to add inventory to existing stores and to open several new stores. Financial statements and related footnotes, a description of the company, biographies of its key executives and a set of calculated financial statement ratios and cash flow data were provided to each participant.

Five slightly different scenarios were used (each loan officer received one set of application materials and evaluated only one scenario). Two loan applications presented the company with no change in accounting principle. The applications were identical except for the wording of the auditor's report; group 1 received the old standard report, while group 2 was given the new standard report.

The three remaining loan applications were similar to the first two, except they showed the company had changed its depreciation method, which resulted in an 8% ($26,000) aftertax increase in net income. The effect of this change, in accordance with Accounting Principles Board Opinion no. 20, *Accounting Changes*, was properly noted as a separate item on the income statement. Referred to as *change cases*, these last three loan applications were identical to each other except for the type of audit report included.

The first group (group 3) received the new *modified* unqualified consistency report with the required additional paragraph. Group 4 received the old *except-for* qualification (due to the principle change); group 5 received the new standard unqualified report with no reference to the inconsistency. All other information, including descriptive footnotes of the change, was identical.

The change-case loan applications were developed to test SAS no. 58 reporting requirements as well as the ASB's original position that the reference to consistency be eliminated entirely, even for companies making accounting changes. Although there is no such requirement today, it's possible such a requirement may be adopted in the future.

In evaluating the case materials, bank loan officers were asked individually

■ How confident they were the CPAs were independent in performing the audit.

EXECUTIVE SUMMARY

■ IN 1988, THE AMERICAN INSTITUTE of CPAs auditing standards board established new wording for the standard unqualified audit report and also revised reporting requirements and the types of audit reports allowed.

■ BANK LOAN OFFICERS WERE surveyed in 1989 to determine how this group of users perceived the new audit report. Survey participants reviewed a sample loan application with five different scenarios.

■ THE SURVEY FOUND the new standard audit report wording did not appear to affect significantly bankers' perceptions of auditors or the integrity of financial statements or their overall satisfaction with the report. This was the AICPA auditing standards board's intended result when it issued the revised report—to clarify but not change the auditor's role

■ THE OLD AUDIT REPORT made loan officers more confident there were no material misrepresentations in the financial statements. Users gave relatively low satisfaction ratings to both the old and new standard report wordings. More work may need to be done to increase the reports' effectiveness for users.

■ How confident they were the financial statements conformed with generally accepted accounting principles.

■ How confident they were the financial statements were free of unintentional material errors.

■ How confident they were the financial statements were free of intentional misrepresentations.

■ How satisfied they were with the information provided in the auditor's report.

Loan officers indicated their confidence or satisfaction on an 11-point scale with 0 representing no confidence or satisfaction and 10 representing extreme confidence or satisfaction.

THE SURVEY SAYS ...

The exhibit on page 64 summarizes respondents' average ratings of the five questions

EVOLUTION OF THE AUDITOR'S REPORT

Statement on Auditing Standards no. 58, *Reports on Audited Financial Statements*, is the American Institute of CPAs auditing standards boards' most recent attempt to communicate the nature of the auditor's work, management's responsibility and the auditor's responsibility for the financial statements. Before SAS no. 58's issuance, the last substantial revision to the auditor's report was in 1948.

The former report's longevity was thought to have made it more of an unread symbol than a meaningful communication between the auditor and financial statement users. To remedy this perceived weakness without altering the auditor's responsibility, the AICPA auditing standards board modified not only the standard report wording but also the audit report categories to which the U.S. financial community had grown accustomed. In a distinctive break from the old format, the new standard report contains three standard paragraphs instead of two.

Perhaps the most controversial change from the former standard opinion was the elimination of the reference to consistent application of generally accepted accounting principles. The AICPA auditing standards board deemed the old reference redundant due to the adoption in 1971 of Accounting Principles Board Opinion no. 20, *Accounting Changes*, which requires all material accounting changes to be disclosed properly in the financial statements. Hence, the new unqualified report does not contain any reference to consistency when there is no material change in accounting principle, no change in reporting entity, etc.

As a result of a request by the Securities and Exchange Commission, however, SAS no. 58 requires an additional fourth paragraph to be added to the standard report that mentions any change (in accounting principle, reporting entity, etc.) and directs the reader's attention to the appropriate footnote(s) in the financial statements. In this way, the former except-for qualification for consistency was eliminated and replaced with a reference to the inconsistency in the new modified unqualified consistency report only when there was a material change.

SAS no. 58's reporting requirements on consistency reflect a compromise between the ASB and the SEC. The ASB position—as set out in the original exposure draft and maintained throughout the deliberation process—was that any reference to consistency in the auditor's report was redundant and unnecessary. The SEC said consistency was an important financial reporting practice and the auditor's report should refer to both consistent and inconsistent applications of principle, reporting entity, etc. The compromise in SAS no. 58 resulted in eliminating the

■ Consistency reference in the standard unqualified report.

■ Except-for consistency qualified report category and instituted a four-paragraph modified unqualified consistency report to signal consistency departures.

■ Controversial required opinion qualification yet maintained a mechanism to identify companies with consistency departures.

for all five groups. Comparisons were made between

- The two *no-change* groups.
- The group receiving the new modified unqualified consistency report and the group receiving the old except-for qualified report.
- The group receiving the new modified unqualified consistency report and the group receiving the new standard unqualified report not mentioning the change in principle.

No-change groups. The results show no significant differences between the two no-change groups for all responses. Accordingly, the new wording did not affect significantly bankers' perceptions of auditors or the integrity of the financial statements or their overall satisfaction with the report. This was the ASB's intended result in issuing the report. Since only the report's wording changed and not the auditor's responsibility, knowledgeable users such as bank loan officers were not expected to vary significantly in their perceptions because new language was introduced.

One hundred seventy-eight bankers participated in a survey to assess the impact of the new standard unqualified audit report and the new modified unqualified consistency report.

One interesting result, however, was that the bankers had a higher average level of confidence about the auditors and their work (average rating of the first four questions: 7.57) than their satisfaction with the auditor's report (average rating of the last question: 5.90), with the new auditor's report receiving the lower satisfaction rating. One possible explanation is the audit report historically has not provided lenders with the information they want or need, resulting in relatively low satisfaction ratings for both the new and old reports. Assessing future satisfaction levels in a variety of contexts ultimately will determine if the revised report proves more useful than its predecessor.

Change groups. For bankers receiving applications with a change in accounting principle, the first set of comparisons was between the new modified unqualified consistency report and the old except-for qualified report (groups 3 and 4). The exhibit shows the two groups differed significantly on the *absence of intentional misrepresentations* and *satisfaction with the audit report* questions. Contrary to expectations, the old except-for report made loan officers more confident there were no material misrepresentations in the financial statements than did the new modified unqualified consistency report. However, respondents were significantly more satisfied with the new modified unqualified consistency report than they were with the old except-for qualified report. In addition, the satisfaction rating for the new modified unqualified consistency report was the highest for all five groups. In general, the loan officers' perceptions were fairly consistent over the two types of audit reports for companies changing an accounting principle. However, satisfaction increased substantially for the new consistency reporting requirements.

To test the ASB's original position that all references to consistency be eliminated, the last set of comparisons was between the group receiving the new modified unqualified consistency report and the group receiving the new unqualified report not mentioning the accounting change (groups 3 and 5). These comparisons also helped assess the impact on users had a compromise on consistency not been reached with the Securities and Exchange Commission (see the sidebar for background).

The exhibit shows the bankers' confidence levels that CPAs were independent were significantly different for these two groups, with the required new modified unqualified consistency report (group 3) eliciting much higher confidence ratings than just the new audit report with no reference to the consistency departure (group 5). All other confidence ratings also were higher for the required new report, although they were not statistically significant.

Bankers receiving the new modified unqualified consistency report also had the highest satisfaction, while those receiving the **potential** new consistency report (just the standard unqualified report) had the lowest satisfaction of all groups. This finding suggests the approach to inconsistency the SEC persuaded the ASB to adopt seems to have provided loan officers with the information they need in a form they prefer. The loan officers generally interpreted eliminating the except-for qualification for consisten-

Summary of average responses

	No change groups			Depreciation change groups				
	(1) Old standard report	(2) New standard report	Probability groups 1 and 2 are equal	(3) New consistency report	(4) Old except-for report	Probability groups 3 and 4 are equal	(5) New standard report	Probability groups 3 and 5 are equal
	N=34	N=25		N=31	N=42		N=46	
Independence	7.47	7.92	.33	7.32	7.31	.98	6.59	.09
Conformity with generally accepted accounting principles	7.79	7.04	.24	7.38	7.40	.95	6.94	.29
Absence of errors	7.47	6.92	.36	7.09	6.86	.60	6.36	.12
Absence of intentional misrepresentation	7.88	8.08	.73	7.22	7.90	.08	6.51	.13
Satisfaction with audit report	6.03	5.76	.69	6.84	6.00	.08	5.64	.01

N = Number of bank loan officers in the group.

cy coupled with the new modified unqualified consistency report as satisfactory reporting changes.

WHAT IT ALL MEANS

As the ASB intended, the new standard audit reporting requirements under SAS no. 58 did not appear to have a significant effect on loan officers' perception ratings when compared with the old standard report. This was the desired result—for the new report to clarify, but not change, the auditor's role in performing an audit. However, the relatively low satisfaction ratings for both old and new standard audit report wordings were troubling. These findings suggest there may be a considerable amount of work left if the standard audit report is to be substantially more effective as a means of communicating with users.

The new modified unqualified consistency report, however, was perceived by the bankers to provide a significantly higher level of satisfaction than the former except-for consistency qualification. Additionally, the new reporting requirements for companies that changed principles elicited higher ratings of confidence in CPAs and in the integrity of the financial statements, as well as higher ratings of satisfaction with the report, than did reports that didn't mention the accounting change. These findings support the consistency reporting requirements adopted in the current standards and suggest a positive effect of the SEC compromise.

CHANGED PERCEPTIONS

This project represents an early attempt to gather evidence on users' changed perceptions of the new audit reports. Further work should be done for these and other types of audit reports adopted in SAS no. 58 to see how loan officers and other users perceive the reports after they have been in circulation longer. Such efforts would help the ASB identify areas where communications between auditors and report users can be enhanced. ■