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In Our Opinion ...

A New Audit Report Attempts to Close the Expectations Gap

By Mark W. Lehman, CPA, MBA and James H. Thompson, Ph.D., CPA

Independent public accountants audit financial statements to enhance the public's confidence in the reliability of such statements. The auditor's report is the primary means through which auditors communicate this reliability to the financial community. Unfortunately, there often exists a significant difference between the level of confidence perceived by the user and the level of confidence (assurance) provided by the auditor. This well-publicized "expectations gap" becomes all too apparent when a business collapses. The investing public often blames the auditor for not forecasting the collapse in the auditor's report.

The accounting profession, responding to growing criticism from the investing public, government agencies, and congressional leaders, issued nine Statements on Auditing Standards (SASs) in 1988. One of these standards, SAS No. 58, *Reports on Audited Financial Statements*, revises the auditor's standard report.

A Comparison of the Old and New Audit Reports

The new audit report (presented in the sidebar) is required for audit reports dated on or after January 1, 1989. The traditional two-paragraph report has been expanded to three paragraphs by including a paragraph that explains the nature of an audit. Differences between the old and the new audit reports these differences are found in the report title and in the introductory, scope, and opinion paragraphs of the report.

Report Title

Generally accepted auditing standards (GAAS) require an auditor to be independent both in fact and appearance. Although the old report implied independence in its reference to GAAS, the new report explicitly labels the report as the "Independent Auditor's Report."

Introductory Paragraph

The introductory paragraph identifies the entity audited, the financial statements presented, and the time periods of the financial statements. This information was contained in the scope paragraph of the old audit report.

The word "expanded" has been replaced by the word "Audited." For years, auditors have assumed that users understood that an examination of financial statements

was achieved through an audit. The new report uses the word "audited" instead of "examined" in an attempt to eliminate any confusion.

Added to the introductory paragraph are two sentences that identify the responsibilities of both management and the auditor. The new report explicitly states that the responsibility for the content of the financial statements rests with the management of the entity. This clarifies for the reader that it is management's responsibility to prepare the financial statements and the related disclosures. The second sentence that has been added acknowl-

EXHIBIT 1

Auditor's Standard Report

Independent Auditor's Report

We have audited the accompanying balance sheet of X Company as of December 31, 19XX and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

(Signature)
(Date)

edges the auditor's responsibility to express an opinion on the financial statements based on his audit.

Scope Paragraph

The old report contained a sentence stating that (1) the examination was made in accordance with GAAS and (2) the auditor performed the tests considered necessary in the circumstances. This sentence has been deleted in favor of a new scope paragraph that presents an expanded explanation of the audit process, as defined by GAAS. The new scope paragraph includes five phrases which are new to the auditor's standard report. These phrases, together with a brief explanation, follow:

(1) "... we plan and perform the audit ..." This phrase indicates that the auditor determines the level of audit risk and prepares a written plan that explains the justification for the tests to be performed during the audit. Detailed audit programs are created based on the audit plan.

(2) "... to obtain reasonable assurance ..." Since less than 100% of the transactions are tested, there is a risk that an error in the financial statements will not be detected. The language here clarifies that although the auditor attempts to minimize this risk, the auditor is unable to provide users with absolute, 100% assurance that the financial statements are correct.

(3) "... an audit includes, on a test basis, evidence supporting the amounts and disclosures ..." This clause makes clear that GAAS permits auditors to test less than 100% of an entity's transactions by testing an adequate number of representative transactions. The auditor uses observation, confirmation, inquiry, inspection, and other techniques to obtain evidence that support how management has recorded the transaction.

(4) "... an audit also includes an assessment of the accounting principles used ..." This statement draws attention to the fact that in cases where more than one accounting principle may be used, the auditor determines if the methods selected by management result in the most meaningful financial information. For example, a change from FIFO to LIFO can only be justified if LIFO results in financial statements that better present

EXHIBIT 2

Comparison of Report Formats

SAS No. 58, "Reports on Audited Financial Statement," revises the auditor's standard report. For the most significant changes, an excerpt from the SAS No. 58 format of the auditor's standard report is presented first. The italicized information describes the change from the old report format.

TITLE

INDEPENDENT AUDITOR'S REPORT

Adds reference to independence

WORK PERFORMED

"We have audited ..."

Changes "examined" to "audited"

RESPONSIBILITY

"These financial statements are the responsibility of the Company's management."

Adds reference to management's responsibility

AUDITOR'S ROLE

"Our responsibility is to express an opinion on these financial statements based on our audit."

Adds reference to auditor's role

SCOPE AND NATURE OF AN AUDIT

"Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation."

Contains an expanded explanation of the nature and scope of an audit - the old report format merely stated that the examination "...included such tests of the accounting records and other such auditing procedures ..."

AUDITOR'S JUDGMENT

"We believe that our audit provides a reasonable basis for our opinion."

The old report format stated that auditor performed tests and procedures "as we considered necessary in the circumstances."

THE OPINION

"In our opinion, the financial statements ... present fairly, in all material respects, ..."

Adds the phrase "in all material respects"

CONFORMITY WITH GAAP

"... in conformity with generally accepted accounting principles."

Eliminates the reference to the consistent application of generally accepted accounting principles

the results of operations.

(5) "... and significant estimates made by management ..." The phrasing here acknowledges that generally accepted accounting principles (GAAP) require management to make numerous judgments that directly impact the financial statements. Estimating the allowance for uncollectible accounts is a typical example. The auditor is responsible for determining if management's estimates are reasonable.

Although the procedures described are presently part of financial audits performed in accordance with GAAS, the new report explicitly states that the auditor performs these procedures.

Opinion Paragraph

Some accountants had recommended that the phrase "presents fairly" be eliminated. The new report retains the phrase; however, the phrase "in all material respects" has been added to clarify the meaning of "presents fairly." The phrase implies that the concept of materiality was used both by management in the preparation of the financial statements and by the auditor in the audit of the financial statements.

The report's reference to the consistent application of GAAP has been deleted since it is understood that financial statements prepared in accordance with GAAP are required to apply GAAP consistently among reporting periods. However, SAS No. 58 revises the second reporting standard of GAAS to require a separate explanatory paragraph in the audit report when accounting principles have not been applied consistently.

Finally, the reference to "changes in financial position" has been deleted since SFAS No. 95 replaced that statement with a statement of cash flows. Significant changes between the old and new forms of the auditor's standard report are summarized elsewhere in this article.

Conclusion

The standard auditor's report in SAS No. 58 is part of the accounting profession's attempt to close the "expectations gap." How well does the new audit report close the

expectations gap? This is a question which can only be answered with time, experience, and research. The success of this new audit report will depend primarily upon the reactions of the financial community. Stockholders, investors, bankers, and other interested parties should express their opinions of the new report to the ASB and, if requested, participate in research to determine the effectiveness of the report. Only with this input can the accounting profession continue to improve its communication with the financial community.

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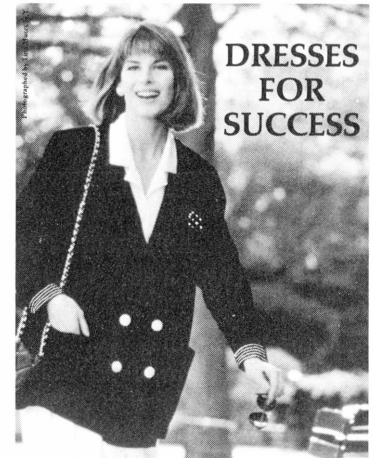
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