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SUBSTANCE AND SEMANTICS IN THE AUDITOR'S STANDARD REPORT

Abstract: The most recent effort at restating the auditor's standard report, SAS 58, is the most comprehensive statement of the auditor's role that has ever been adopted. It is an acknowledgment that the previous report had become an ineffective communication of the audit function and was perhaps too cautious in circumscribing the auditor's public responsibilities. This paper compares and analyzes the terminology of the standard report throughout the professions's history with particular emphasis on the recent years leading up to *SAS 58*. An exhibit compares the parallel terminology and the social, economic and political issues that resulted in each revision. Additionally, some assessment of the potential future changes to the report are presented.

"In a simple matter such as an auditor's certificate we fail to see why any legal interference is called for. What the public and shareholders want is a readable assurance from the accountants, stating in plain English what they really have done" [*The Accountant*, 1883].

This statement is as fitting today for the public accounting profession in the United States as it was more than 100 years ago in the United Kingdom. The public accounting profession then, as now, was searching for an effective statement to the public and the shareholder that would tell "what they really have done" when an audit had been performed. The profession has responded many times to this same request by modifying the auditor's standard report to be a more effective communication. However, the gap between the reality of what the auditor has done and the public and shareholder's perception of what has been done has persisted, or is at least repeatedly reopened.

The "gap" that has been the focus of discussion for more than a decade has two dimensions, a semantic dimension and a substance dimension. The semantic dimension is concerned with the common understanding of the terms and concepts used in the auditor's standard report. Terms and concepts used may have different meanings for the professional accountant and the public. The substance dimension of the "gap" concerns the beliefs and expectations of the public and shareholders regarding the work of the auditor and the assurance that should be provided versus the work and assurances that the auditor is willing or able to provide.

The historical development of auditing and the audit report has been the result of several influences that may be characterized as political, social, economic, legal, and professional [Choi, 1984; Kaplan, 1987]. These influences often have had an interdependent and collective effect on auditing developments, yet a particular influence may appear to have been the predominant influence. For example, auditing developments of the preregulation period were predominantly influenced by economic factors. Without legislated directives, audits were primarily based on management's cost-benefit assessment. During this period, other influences, such as the Federal Reserve Board, the accounting profession, and later, the New York Stock Exchange, were working to establish uniformity for auditing, audit reports and financial reports. In the 1930s, legislation established that the social welfare must be protected by auditing and financial reporting standards. Since that time, the Securities and Exchange Commission, accounting profession, business interests, and individuals seeking legal restitution have influenced the development of auditing and audit reporting standards.

The interaction of these various interests is illustrated well by the *McKesson-Robbins* case. Plaintiffs seeking financial restitution were successful because a major weakness was exposed in auditing procedure. The accounting profession responded by changing audit procedure and changing the audit report accordingly. The SEC also responded to the audit deficiencies identified in the *McKesson-Robbins* case and prescribed certain auditing and reporting procedures. The accounting profession quickly responded a second time and incorporated the directives of the SEC. While the details of these events are presented later in this paper, the discussion here is sufficient to illustrate the interactive and collective affect of several influences in the development of auditing procedures and the audit report.

An effective illustration of semantic and substantive changes to the audit report can also be found in the changes made to the report following the *McKesson-Robbins* case. Prior to the case, the report referred to the auditor's interview of management as an audit procedure. The deception perpetrated by management in the case was embarrassing because it suggested naivete, vulnerability, and perhaps, lack of independence. Reference to this procedure was dropped from the audit report, even though the interview procedure continued and is still a useful procedure. It was a semantic change rather than a substantive change. A semantic change that has remained somewhat enigmatic was the change from "fairly present" to "present fairly." Substantive changes also resulted from the *McKesson-Robbins* case. As noted above, auditing procedures were expanded to verify certain assets and the audit report generally described these changes of auditing procedure. This paper describes the semantic and substantive changes to the standard audit report in the past century, and suggests possible future semantic and substantive changes.

The public accounting profession's most recent effort at restating the auditor's standard report, *Statement on Auditing Standards No. 58* — "Reports on Audited Financial Statements" [AICPA, 1988], is the most comprehensive statement of the auditor's role that has ever been adopted. As in previous versions of the auditor's standard report, the words and concepts were carefully selected. In *SAS No. 58,* however, the Auditing Standards Board appears to have taken special care in selecting terminology that would be appropriate professionally and that would convey an accurate understanding for public users. This observation is given perspective, when the new standard is compared to the versions that have existed in the past, and when the dynamics of social, economic and political forces that have shaped each successive version are evaluated.

This discussion will focus on the historical development of the auditor's standard report, from the early versions to the form prescribed in *SAS No. 58*. Particular emphasis is placed on the terms and concepts that were added, deleted and modified in successive versions. Some of these changes were based on substantive changes in the work of the auditor. A summary and comparison exhibit is presented, to enhance understanding of the historical development and the changing terminology. Finally, observations are made about possible future semantic and substantive changes.

COMPARATIVE ANALYSIS OF THE AUDIT REPORTS

The development of the standard audit report in the United States will be analyzed, with particular attention given to the terms and phrases that were used in audit reports and the influences that led to the changes in the report. As noted above, *SAS No. 58* requires the most comprehensive report form in history. It requires that the report explicitly address the responsibilities of the auditor, the work which the auditor performs, and the assurance which the auditor provides [Roussey, 1988]. Exhibit I presents an analysis of the terms and phrases prescribed in *SAS No. 58* on the basis of three categories (responsibilities, work, and assurance). The terms and phrases of each of the preceding versions of the report are also analyzed on the basis of these three categories. For the purpose of comparison, a parallel concept or meaning that has appeared in one or more versions is presented on the same line in each column. For example, the degree of accuracy for the auditor's assurance has been expressed by three different phrases since 1917 and several before 1917. Since they were all expressions of the degree of accuracy, they were presented on the same line of the exhibit. A term or phrase that does not have a parallel expression in another version of the report is presented on a line by itself, such as the term "independent" as expressed in the report title required by *SAS No. 58*. The events or circumstances (economic, political, social, legal, or professional) that precipitated the change are noted in a summary form at the top of each column.

Perhaps the most common public impression of accountants is that they are quantitative experts, able to express business events numerically. A study of the development of the standard audit report, as shown in the summary and comparison and as discussed in the following sections, makes it clear that standard setting for the auditing profession also requires the skill of a semanticist.

BRITISH INFLUENCE

The auditing profession in the United States evolved from British origins in the nineteenth century. Two major aspects of British history contributed to the development of the professional accountant and the accountant's work product, the audit. First, the history of financial crisis, bankruptcies and governmental control over bankrupt entities increased the demand for expert accountants to serve the interest of the public. Second, the re-establishment of the joint-stock company created a demand for the professional auditor.

The history of business in nineteenth century England is a succession of prosperity, crisis and depression [Littleton, 1933]. The inevitable consequences of these recurring periods of depression were heavy financial losses and business failures. Understandably, bankruptcy occupied the public mind a great deal. Parliament, unable to control the swings of reckless speculation and convulsive panic, attempted to develop constructive legislation in the years following each crisis, to secure better protection for creditors. Each statute placed responsibility on an individual or individuals for administering the bankrupt's estate to the best interest of all concerned. Naturally, a substantial amount of accounting work was involved, to maintain accurate accounts and to insure that the statements were correct. Knowledgeable accountants experienced increasing demand. The legislated necessity of expert and trustworthy accountants to provide an accurate and equitable report to the public on the affairs of bankrupt entities was a significant development for professional accountancy and for the audit function [Littleton, 1933].

A second major development was the restoration of the joint-stock company. The abuses of the eighteenth century stock companies had culminated in the Bubble Act of 1719, which prohibited joint stock companies. After more than 100 years, a new act again permitted joint stock companies to be formed. The act was careful to provide some safeguards against the actions of promoters and directors. Certain sections required auditing of the accounts by someone independent of management, and either an auditor's special report on the accounts or a confirmation of management's report. Every auditor was to be supplied with a copy of the company balance sheet to examine. He was then required to report to the shareholders "whether in (his) opinion the balance sheet is a full and fair balance sheet containing particulars required by these regulations and properly drawn up so as to exhibit a true and correct view of the state of the company's affairs" (Sec. 94) [Littleton, 1933]. This report, in effect, constituted a certificate. Until 1900, it appears to have been general practice for auditors merely to sign balance sheets or to add some phrase such as "audited and found correct" [Hopkins, 1984].

The British experience in the development of the auditing profession, in particular the development of the auditor's report, is relevant and instructive because the accounting system, auditing process, and audit reports in the United States were derived from the British experience. It is particularly important to note that the social, economic, and political events in England led to the legislated establishment of the auditor and the content of the auditor's report long before legislation addressed the auditor's role in the United States. The British experience, therefore, provided a useful reference for practice in the United States, particularly up to the

Exhibit 1
Evolution of the Standard Short-Form Audit Report

Year of Report Change	**1988**	**1948**	**1941**	**1939**
Motivation for Report Change (Economic, Social, Legal, Political, Professional	Governmental investigation Profession's investigation Litigation Legislation	AICPA's response to the SEC's 1941 report	SEC's report following the *McKesson* and other audit failure cases	AIA's response to the *McKesson* and other audit failure cases
Content of the Auditor's Standard Short-Form Report				
1. Responsibilities **a. Relationship of the Auditor and Management**	**"Independent"** stated in the report title			
b. Work of Auditor	**Express an Opinion** on management's financial statement			
2. Work **a. General Procedures** **b. Specific Procedures**	**Audit** the **BS, IS RE, SCF** **Conducted** in accordance with **GAAS**	**Examined** the **BS, IS & Surplus** **Examined** in accordance with **GAAS** & other auditing procedures considered necessary	**Examined** the **BS, IS & Surplus** **Examined** in accordance with **GAAS** & procedures considered necessary	**Examined** the **BS, IS & Surplus**
	Examining on a test basis amounts and disclosures	**Tests** of the accounting records	**Examined** or **Tested** the accounting records & other supporting evidence by methods & to the extent appropriate **Without a Detailed Audit** of transactions **Reviewed** the system of internal control	**Examined** or **Tested** the accounting records & other supporting evidence by methods & to the extent appropriate **Without a Detailed Audit** of transactions **Reviewed** the system of internal control
c. Minimum Objectives	**Assessing** accounting principles & significant estimates **Evaluating** overall financial statement presentation **Reasonable Assurance** that financial statements are free from material misstatement **Reasonable Basis** for our opinion			
3. Assurance **a. Basis**	in our opinion	in our opinion	in our opinion	in our opinion
b. Degree of Accuracy	present fairly in all material respects	present fairly	present fairly	present fairly
c. Comparability & Authoritative Guidance	**GAAP**	**GAAP** applied on a basis consistent with the preceding year	**GAAP** applied on a basis consistent with the preceding year	**GAAP** applied on a basis consistent with the preceding year

1934	1931	1929	1917	Before 1917
Securities Act of 1933, 1934, market crash, depression, New Deal politics & economics, senate investigations	*Ultramares* case-third party liability standard established	Income statement added: AIA/FRB "Verification of Financial statements	"Uniform Accounting". AIA/FRB, to promote more uniform accounting	Extension of the British system of accounting & reporting
Examined the **BS, IS & Surplus**	**Examined** the accounts	**Examined** the accounts	**Audited** the accounts	**Examined** or **audited** the book & accounts
Examined or **Tested** the accounting records & other supporting evidence				
Without a Detailed Audit of transactions				
Obtained information & explanations from officers & employees				
General Review of the accounting mehods & the operating & income account				
in our opinion	in our opinion	... certify that* ... **in our opinion**	... certify that* ... **in our opinion**	... certify that ... **in our opinion**
present fairly	set forth	set forth	set forth	"properly drawn," true," "correctly present"
accepted principles of accounting consistently maintained during the year under review			plan suggested by the **Federal Reserve Board**	

*"Certify" is more clearly related to the "plan" than the "opinion"

point where legislation and case law began to define the auditor's role [Cochrane, 1950].

EARLY VERSIONS OF THE AMERICAN AUDITOR'S REPORT (1890 TO 1916)

While the Companies Act of 1900 and subsequent acts prescribed the contents of the auditor's report for British audits, the lack of statutory requirements for audits in the United States meant that the client likely perceived that the benefits of a detailed audit would exceed the costs. It is not surprising then that in most cases the detailed audit procedure of the British accountants was viewed as too costly. Without the uniformity of audit objective and procedure, it is not surprising that the audit report was also not uniform. The auditors variously described their work as an audit or examination of the books, the accounts, or both the books and accounts. Assurance was expressed by stating that "we (the auditors) certify that, in our opinion, the balance sheet" either "correctly sets forth;" "exhibits a true and correct view;" "accurately accords conditions;" "represents the true financial position;" or "is a true and correct transcript of the assets and liabilities appearing on the books." The separate responsibilities of the auditor and management were not explicitly addressed [Edwards, 1960], [Flesher, 1980], [Montgomery, 1916].

AN ATTEMPT AT STANDARDIZATION (1917)

The varied expressions found in the auditor's report led to confusion and misunderstanding. Many shareholders believed that the auditor's report represented a guarantee [Flesher, 1980]. The Federal Trade Commission requested that the American Institute of Accountants (AIA) prepare a booklet entitled *A Memorandum on Balance Sheet Audits*. The Federal Reserve Board (FRB) published it in the *Federal Reserve Bulletin* of April 1917 and subsequently reprinted it under the titles *Uniform Accounting: A Tentative Proposal by the Federal Reserve Board* and *Approved Methods for the Preparation of the Balance Sheet Statements*. The booklet suggested that the auditor's report have the following wording:

> I have audited the books and accounts of Blank and Co. for the period from . . . to . . . and I certify that the above balance sheet and statement of profit and loss have been made in accordance with the plan suggested and advised by the Federal Reserve Board and in my opinion set forth the financial condition of the firm at . . . [Carey, 1969].

The work of the auditor is described by the brief phrase "audited the books and accounts." The basis of the auditor's assurance is opinion. The accuracy characteristic may be viewed as having two dimensions. First, the report certifies that the balance sheet and the statement of profit and loss (shown without support as one figure on the balance sheet) are in accordance with the suggested plan of the FRB, the first reference to an authoritative source for guidance in determining appropriate accounting numbers and disclosure. The second aspect of accuracy is that the statements "set forth" the financial condition of the firm, which is less specific than the terms "true and correct" previously used.

Because the FRB lacked legislative authority to prescribe accounting practice, diversity persisted in accounting practice and reporting. Later, in the 1920s, accountants began to object to certain deceptive accounting practices by making qualifications to their reports with the phrase "subject to" [Flesher, 1984].

THE INCOME STATEMENT GAINS PROMINENCE (1929)

In 1929, a committee of the AIA revised and retitled the booklet, *Verification of Financial Statements,* and it was published by the FRB. The suggested auditor's report form was as follows:

> I have examined the accounts of . . . Company for the period from . . . to . . . I certify that the accompanying balance sheet and statement of profit and loss, in my opinion, set forth the financial condition of the company at . . . and the results of operations for the period [Carey, 1969].

The terminology describing the general work of the auditor was changed from "audited the accounts" to "examined the accounts." Regarding the basis of assurance, the auditor certified that an opinion was being expressed. Regarding assurance of accuracy of the statements, the term "set forth" was retained from the previous version. Prior to 1929, the results of operations had been presented as a single profit or loss number. This practice was changed; a detailed profit or loss statement was to accompany the balance sheet. (The British Companies Act of 1929 also initiated the requirement that a detailed profit and loss statement accompany the balance sheet.) [Hopkins, 1984] Although information from prior years was to be included with the statements, comparability was not mentioned in the report. Reference to the FRB was dropped.

ULTRAMARES AND THIRD PARTY LIABILITY (1931)

The *Ultramares* case in 1931 increased the awareness of the importance of the words used in the report. The *Ultramares* case was a third party lawsuit against an accounting firm. The charge was negligence in the performance of an audit. The court ruled that, in the case of negligence, the auditor was only liable to his client. If the auditor's performance was proven to be gross negligence or fraud, however, the auditor was responsible to third parties. Following *Ultramares*, the *Journal of Accountancy* (July 1931) reported that "the word 'certify' which had been used for many years was inappropriate and should be abandoned." Its use conveyed that accounting data was subject to precise measurement and that the auditor was capable of guaranteeing exactness [Brasseaux, 1972]. The word "certify" was dropped from the report. Clearly the omission of this term did not alter the nature of the assurance, which was "opinion." Additionally, the accounting profession hoped that the report would no longer be referred to as a "certificate" [Murphy, 1952].

LEGISLATIVE AUTHORITY — THE FIRST STANDARD REPORT (1934)

In the years immediately following the 1929 stock market crash, the public understandably viewed the business community with fear and mistrust [Flesher, 1980]. Business leaders and the accounting profession recognized the desirability of restoring the public trust. With that purpose in mind, conferences began between a committee of the New York Stock Exchange (NYSE) and a special committee of the AIA. In January 1933, the NYSE began to require annual audits by independent auditors before a corporation could be listed. In this same period of time, the Securities and Exchange Commission (SEC) was formed to articulate accounting standards for companies that publicly traded their securities. The SEC was given the power to prescribe the form and content of the auditor's certificate:

> The certificate of the accountant or accountants shall be dated, shall be reasonably comprehensive as to the scope of the audit made, and shall state clearly the opinion of the accountant or accountants in respect to the financial statements of, and the accounting principles and procedures followed by, the person or persons whose statements are furnished . . . Nothing in this rule shall be construed to imply authority for the omission of any pro-

> cedure which independent public accountants would ordinarily employ in the course of a regular annual audit [Greidinger, 1939].

Supported by the authority of the NYSE and the SEC, the suggested report form of the AIA became the first standard auditor's report. The SEC's rule requiring a comprehensive scope and clear opinion was addressed by dividing the report into two paragraphs, one paragraph to discuss the scope or work of the audit, the other to discuss the opinion or assurance given by the auditor. The report was as follows:

> We have made an examination of the balance sheet of the XYZ Company as of December 31, 1933, and of the statement of income and surplus for the year 1933. In connection therewith, we examined or tested accounting records of the company and other supporting evidence and obtained information and explanations from officers and employees of the company: we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.
>
> In our opinion based upon such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the year under review, its position at December 31, 1933, and the results of its operations for the year [Murphy, 1952].

The relatively detailed description of the auditor's work was a significant change from previous recommendations. The auditor's work was described as "an examination of the balance sheet and the statement of income and surplus" rather than "an examination of the accounts." Following this general statement, the specific audit work was described: "examined or tested accounting records and other supporting evidence," "obtained information and explanations from officers and employees", "made a general review of the accounting methods and of the operating and income accounts." The last phrase emphasized the limited nature of the audit work, "we did not make a detailed audit of the transactions."

The second paragraph described the basis of the auditor's assurance as, "In our opinion." Regarding assurance of the accuracy of the statements, the phrase "fairly present" replaced the phrase "set forth." The term "fairly present" suggested that judgment was involved in the measurement and disclosure of economic events. The phrase "present fairly" was a much discussed alternative.

The frame of reference for determining a fair presentation was noted as "accepted principles of accounting." This is the first reference to the profession's body of knowledge as an authoritative source for guidance in determining appropriate accounting numbers and disclosure.

A concluding feature of the auditor's assurance was that the accounting principles used by the company were "consistently maintained," thereby asserting the comparability of the numbers presented in the current period with the numbers of preceding periods. It is logical and understandable that accounting principles would have to be consistently maintained to produce statements that were a fair presentation, but an explicit statement on this point added emphasis. Any material changes in accounting principles or their application were to be disclosed.

The AIA did not recommend a title for the report, but did instruct that the report be addressed to the directors of the company or the stockholders if the appointment was made by them.

At the time of this major revision in the auditor's report, the business and political climate was characterized by change in the New Deal era. Of concern to the accounting profession was the creation of the SEC in 1934, with authority to prescribe accounting practice. In the next four years, the SEC was fully occupied with the development of its own organization and with the problems of the capital markets. Consequently, the Commission did not begin to evaluate and prescribe accounting and auditing standards. At the same time, many leaders in the accounting profession were concerned about the ramifications of having the profession directed by a government agency. Through the offices of the AIA, leaders of the profession approached the SEC to offer to assume the authority for establishing accounting standards. In 1938, in a close vote, that proposal was approved. The Commission retained an oversight responsibility and the right to intervene should the AIA develop an inappropriate standard or fail to deal with an issue that the Commission felt needed attention [Wyatt, 1987].

It is important to recognize that the Commission's action to transfer the responsibility for developing accounting standards and auditing practice to a private sector entity was not approved by Congress in 1938 or at any subsequent date. The arrangement is therefore sustained on the basis of convenience, convention and acceptable performance.

McKESSON & ROBBINS — THE PROFESSION'S RESPONSE (1939)

The McKesson & Robbins Company fraudulently overstated assets in its audited 1937 financial statements. Despite traditional audit steps being followed, the fraud went undetected by the auditors. This deception was created by fictitious entities and fictitious documentation and the deception succeeded because accounts receivable were not confirmed, inventory was not physically verified, bank balances were verified by company documents only, and intercompany sales were not examined [Greidinger, 1939]. The SEC and the AIA studied this case to evaluate the adequacy of audit procedures.

Before the SEC's evaluation was made known, the AIA adopted the report, *Extensions of Auditing Procedure.* The purpose of the report was to correct the failures of past audit procedures as evidenced in the *McKesson & Robbins* case *[Journal of Accountancy*, 1941]. This report was formally approved in September 1939, and was the first *Statement on Auditing Procedure*. The statement presented a broad view of an auditor's duties and outlined new procedures for auditing inventories and confirming receivables. A new audit report form introduced an emphasis on internal control.

> We have examined the balance sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company and, without making a detailed audit of the transactions, have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.
>
> In our opinion, the accompanying balance sheet and related statements of income and surplus present fairly the position of the XYZ Company at April 30, 1939, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

There were several changes to the work and assurance paragraphs of the 1933 version of the report. The general work was still described as an examination of the balance sheet and statements of income and surplus. However, the description of the specific work of the audit was significantly changed. The report retained the phrase "examined or tested accounting records and other supporting evidence," but added the qualification "by methods and to the extent we deemed appropriate." This qualifying phrase clearly highlighted the judgment aspect of audit procedure. The phrase "without a detailed audit of the transactions," was retained from the 1933 version.

Perhaps the most significant amendment in response to past audit deficiencies was the statement that the auditor has "reviewed the system of internal control and the accounting procedures." Related to that adjustment was the deletion of the phrase "obtained information and explanations from officers and employees." Although auditors continued to obtain information from officers and employees in conducting an audit, the *McKesson* case had made this statement a source of embarrassment and suggested a lack of independence.

Also deleted was the phrase "general review of the accounting methods and of the operating and income accounts." In view of the other expressions, this phrase appeared redundant.

The assurance section of the auditor's report still began "In our opinion," to describe the nature of the assurance. The phrase to describe the accuracy of the statements was changed to "present fairly" from "fairly present." Although this change was extensively debated, the significance of this change was not disclosed [Flesher, 1980]. The authoritative source of guidance in selecting accounting principles was changed to "generally accepted accounting principles" from simply "accepted accounting principles" suggesting that wide acceptance among accounting professionals was required.

To enhance the assurance of comparability and clarify the application of this concept, the new version stated that the principles were "applied on a basis consistent with that of the preceding year" rather than simply "consistently maintained during the year under review."

McKESSON & ROBBINS — THE SEC'S RESPONSE (1941)

After the McKesson & Robbins hearings, the SEC issued a report that was critical of the audit conducted by Price Waterhouse and Co. Even though the auditor had followed generally accepted auditing procedures, the Commission stated that the firm had not followed a policy of wisdom and reasonableness to assess the true financial condition.

The Commission recommended that the auditor's report be amended to include a "clear certification" that the audit was adequate for the expression of an independent opinion [*Journal of Accountancy*, 1941]. This recommendation was implemented in the SEC's amended regulation S-X, Rule 2.02(b), which required a statement of the scope of the audit and a specific disclosure of any generally accepted auditing procedures that had been omitted.

The revised auditor's report altered the 1939 version by adding one sentence to the scope of the paragraph.

> Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included all procedures which we considered necessary.

In effect, this requirement represented a minimum level of care in conducting an audit. An omitted auditing procedure would be, by definition, a substandard performance. Ironically, at this time there were no generally accepted auditing standards. The report terminology, "generally accepted auditing standards," was used because it was specified in Regulation S-X. It therefore became a directive to the AIA to establish auditing standards.

GENERALLY ACCEPTED AUDITING STANDARDS (1948)

In response to the SEC's directive to establish auditing standards, a special committee of the AIA prepared a report on auditing procedure, "Tentative Statement of Auditing Standards — Their Generally Accepted Significance and Scope." In this statement, the committee defined auditing procedures as actions, auditing standards were defined as the quality of those actions. Accordingly, a standard would not vary according to the circumstance, whereas, a procedure could vary according to the circumstance [Stettler, 1961].

The "Tentative Statement" was approved at the Institute's 1948 annual meeting and led to a revised auditor's report as specified in *SAP No. 24*, "Revision in Short-Form Auditor's Report or Certificate." The revised report was:

> We have examined the balance sheet of X Company as of December 31, 1948, and the related statements of income and surplus for the year then ended. Our examination

> was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the accompanying balance sheet and statements of income and surplus present fairly the position of X Company at December 31, 1948, and the results of operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year [AICPA, 1948].

The general work of the auditor was still described as an examination of the balance sheet, income statement, and statement of surplus. The description of the specific work of the audit, "a review of the system of internal control," was deleted in recognition that generally accepted auditing standards included this procedure. Note that in this version, as compared to the immediately preceding version, the standards are always applicable, whereas, the procedures are those considered necessary in the circumstances. The recognition of generally accepted auditing standards defined the minimum level of auditor performance. The added clarification that the audit was done "without making a detailed audit of the transactions" was deleted. The assurance portion of the 1948 revised auditor's report was not changed from the wording used in the preceding version.

MINOR WORD CHANGES

In the next 40 years, minor changes were made to the auditor's standard short-form report. A change occurred in 1963 when the term "retained earnings" replaced the term "surplus" to convey the idea that earnings were reinvested in the firm. Recognizing the importance of the source and use of funds to a firm and the usefulness of this information to investors, a "statement of changes in financial position" was required as a part of management's financial report. In 1971, *Statement on Auditing Procedure No. 50* required that the auditor's examination and opinion include the statement of changes in financial position. In 1987, the statement was changed to a "statement of cash flows."

CLOSING THE EXPECTATION GAP (1988)

The latest version of the auditor's short-form report is outlined in *Statement on Auditing Standards No. 58*, "Reports on

Audited Financial Statements," adopted in 1988 and effective January 1, 1989. Based on the 40-year longevity of the previous report form, one would assume that it had been very satisfactory in expressing the work and assurances of the auditor. In fact, pressure to change the report form had existed for more than a decade, but "any new move to change it would, like so many earlier efforts, become ensnarled in an endless debate over words, phrases, interpretations and implications" [Mednick, 1986].

The pressures to change began in the late 1960s and early 1970s when the litigious environment began to change the operating assumptions of the auditing profession. A rash of notorious bankruptcies and frauds, such as Penn Central, National Student Marketing, Equity Funding, and Sterling Homex, shook the public's confidence in the public accounting profession. The accounting and auditing standards failed to deal with the deceptive practices that had led to these business failures. The profession, the SEC, and Congressional committees led by Proxmire, Moss and Metcalf questioned the adequacy of the auditor's report and the adequacy of the audit function in meeting public demands and expectations [Campbell, 1987].

In 1974, during a time of intense Congressional scrutiny, the AICPA appointed the Commission on Auditor's Responsibilities to:

> " . . . develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors. It should consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish. If such a gap does exist, it needs to be explored to determine how the disparity can be resolved."

The Commission concluded in its 1978 report that a gap did exist, caused in part, by the auditor's standard report. The Commission reported that:

> "evidence abounds that communication between the auditor and users of his work — especially through the auditor's standard report — is unsatisfactory . . . Recent research suggests that many users misunderstand the auditor's role and responsibility, and the present auditor's report only adds to the confusion. Users are unaware of the limitations of the audit function and are confused about the distinction between the responsibilities of management and those of the auditor" [AICPA, 1978].

A further dimension to the gap was the expectation that an audit would detect any fraud or error and that the auditor's responsibility also included an interpretative role, assessing the viability and profitability of the firm audited.

The Committee noted that the standard report intended to convey several separate messages, some explicitly and others inferred. It observed that:

> "an auditor's report should state its messages explicitly and not rely on users' inferences . . . the auditor's report should be clear that technical elements are involved in the audit function and should also clearly describe the work of the auditor and his findings and avoid unclear technical terminology concerning details."

A new report form was suggested by the Committee. It was an expansion beyond the traditional two paragraph form, to a series of paragraphs each describing a major element of the audit function as applicable in the specific circumstances of the particular client. The descriptions were to clarify the respective responsibilities of the auditor and management and the limitations of an audit. Furthermore, the Committee suggested that the auditor should evaluate the cumulative effect of the management-selected accounting principles and determine that the financial statements taken as a whole are not biased or misleading. Also, the Committee believed that the word "consistency" could be eliminated, since disclosure rules made reporting on consistency management's responsibility. And it proposed that the "subject to" qualification for material uncertainties should be eliminated. The uncertainty should instead be disclosed in a note which provided users with enough information to make their own evaluation of the uncertainty's potential effect. Finally, the Committee recommended that the word "independent" be used in the title to the report and that the word "audit" replace the word "examined" as the description of the general work of the auditor.

The report of the Committee on Auditor's Responsibilities came at a critical time, because Congress, the SEC, and the profession were debating many of the issues addressed in the report. The Committee's proposals provided significant direction for the profession. Indeed, the general directive regarding how the report should be worded, and most of the recommendations noted above, became the basis for the next proposal and ultimately *SAS No. 58*.

Based on the report of the Committee on Auditor's Responsibilities, the Auditing Standards Board issued an exposure draft proposing a new standard auditor's report in 1980. The proposal would have: (1) added the word "independent" to the title; (2) stated that the financial statements were the representations of management; (3) replaced the word "examined" with the word "audited"; and (4) deleted the word "fairly" from the opinion. Following the comment period, the proposal was withdrawn. One explanation for the withdrawal was that many perceived that the proposed changes were designed to reduce auditor responsibility; the total effect was "not seen as an improvement" for financial statement users.

In the several years that followed, further Congressional investigations, investigations by the profession, litigation reflecting a greater willingness to hold professionals accountable, regulatory agency pressures, and a growing awareness of the widening expectation gap led to the adoption of *SAS No. 58*, "Reports on Audited Financial Statements." This new auditor's standard report is intended to make a contribution to bridging the expectation gap by being more comprehensive in describing the responsibilities, work, and assurance of the auditor. Accordingly, the statement was expanded to three paragraphs to address each of these issues. The recommended report form is:

> *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 posi-

> tion of X Company as of [at] December 31, 19XX, and the results of operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The changes in this new report form reflect the development of ideas and concerns for the public's understanding of the work of the auditor. The title expresses the cornerstone concept of the profession — independence. The beginning paragraph defining the responsibilities of the auditor and of the management also has no precedent in previous versions. In the past, it has been assumed that the public has understood the respective roles of management and the independent auditor. Now that concept is explicitly stated

In the second paragraph, which describes the work of the auditor, several historically established concepts are reworded and several concepts that have never been expressed in the auditor's report are introduced. The general procedures are termed an "audit" of the financial statements rather than an "examination" as it was termed for the past 50 years. The distinction may be too subtle for many readers, yet the balance of the paragraph makes it apparent that an audit is a broader evaluation process than an examination. Regarding the specific procedures, the new report states that the audit was conducted according to GAAS, but "auditing procedures" are not mentioned as in the 1948 version. Since the standards require procedures deemed necessary, reference to the procedures would be redundant.

The new report establishes a minimum objective for the audit, "reasonable assurance that the financial statements are free from material misstatement." This expression explicitly recognizes the statement user's concern regarding misstatement of information (intentional and unintentional), and implies that immaterial errors may possibly not be identified in the audit process.

The report's statement that "An audit includes examining, on a test basis, evidence supporting the amounts and disclosures . . . ," parallels the expression used since 1934 describing the "tests of the accounting records." The obvious difference is that the new version uses the terms "amounts and disclosures," which is perhaps more explicit than the term "records," and which includes disclosures that are a part of external reports.

The specific work of the audit is also described as "assessing the accounting principles and significant estimates." The phrase, "assessing the accounting principles," parallels an expression last used in the 1934 version of the report in which a "general review of the accounting methods" was described. A reference to "significant estimates" is new to the auditor's report. It discloses that a review of estimates is a part of the audit process, and it also highlights the often forgotten premise that accounting numbers involve subjectivity and judgment.

Another new expression in the second paragraph concerns "evaluating the overall financial statement presentation." This is a procedure that auditors already were doing. Furthermore, one could interpret the phrase "present fairly" in the opinion or assurance paragraph to mean that an overall evaluation of the financial statements has been made. The new report, however, makes this point more explicit.

A concluding statement, also new to the second paragraph, states the implicit assumption of the past report versions that the audit work has been sufficient to provide a "reasonable basis for an opinion."

Significant changes were also made in the third paragraph in the description of the auditor's assurance. The basis for the auditor's report is still "opinion," perhaps the most enduring expression in the report. The degree of accuracy represented for the financial statements is modified from "present fairly" to "present fairly in all material respects." This qualification reemphasizes the expression in the second paragraph that the financial statements are free from material misstatements.

A second change in the assurance paragraph of the report is the elimination of the reference to the consistent application of accounting principles. Such reference is required only when there is a lack of consistency. The reference to consistency when accounting principles have been applied consistently was unnecessary after the adoption of *Accounting Principles Board Opinion No. 20, Accounting Changes* [Spires, 1990]. Further, *SAS No. 58,* requires that when there is a departure from consistent application of GAAP, an additional explanatory paragraph be appended to the three paragraph audit report.

A few overall impressions can be developed from the new report form. First, the report expresses some concepts that had been only implicit assumptions of past versions, or that needed revitalized wording. Second, the report is worded to communicate the nature of an audit by using a variety of terms and repetition. Thus, rather than relying only on the terms "examination and tests" to convey the nature of the auditor's work, the terms "audit, planning, examination, testing, assessing, and evaluating" are used. These terms have some overlap of meaning, and individually there are subtle differences of meaning; collectively, they emphasize that audit work is technical and subjective. The terms "reasonable" and "opinion" are each used twice to emphasize the judgment element of the audit and the basis of the auditor's assurance. Also, the concept that the audit may not reveal immaterial misstatements is noted twice in the report. A third point concerns fraud detection. It is understood that misstatement can result from intentional (fraud) or unintentional actions. Although the accounting profession may have assumed that the public interest had shifted as early as the 1930s from prevention or detection of error or fraud to the "fair presentation" of financial statements [Carey, 1973], the public has continued to view fraud detection as an important audit function. It is clear that the profession is recognizing the public concern that fraud detection should be a part of the auditor's role.

FUTURE CHANGES TO THE AUDITOR'S REPORT

The same environment that precipitated the new, "expectation gap" SASs has continued into the 1990s, and will probably be sustained for much of this decade. The savings and loan bailout and bank failures will take years to manage and may alone sustain public skepticism of the system of auditing, oversight and regulation that allowed this condition to develop. Business failures are also unabated, such as the failures of many insurance companies, Executive Life Insurance being perhaps the most spectacular example. These failures and others have resulted in injured parties and lawsuits, some of which continue to challenge the adequacy of the auditing and reporting function.

In this environment, future changes to the auditor's report are likely. The new report has made some significant wording changes as noted above, however, there may be additional opportunities to explain the work and assurances of the auditor. For example, words or phrases that may require more detailed explanation are (1) "audit" (distinguishing an audit from an examination or review), (2) "test basis," (3) "reasonable assurance," (4) "free of material misstatement," (5) "assessing accounting principles" (Is this evaluating the appropriateness of the accounting principle or just that the principle used is a generally accepted accounting principle?), (6) "significant estimates," (7) "overall financial statements," (8) "present fairly," and (9) "all material respects." These terms are candidates for restatement or elaboration because they either (1) have specific professional meaning that needs to be understood by the constituency, (2) have been debated and changed before, and therefore, may be debated and changed again, or (3) suggest the subjective nature of the process which may require explanation.

Substantive changes to the auditor's report may result from expanding management's reporting requirements to a more comprehensive reporting structure. Fifteen years ago, the Accounting Objectives Study Group (Trueblood Commission) broadly defined management accountability to include providing information for stewardship and decision making that would not fit into the historical financial statement and footnote structure. Examples of management reports that would fit into a more comprehensive reporting structure are: (1) a report on the internal control structure, (2) a report on compliance with contracts and applicable laws and regulations, (3) a report on the efficient and economical use of resources, (4) a report on the progress made in achieving goals and objectives, (5) a report summarizing activities designed to deter fraud [Pavlock, 1990], and (6) a report on forecasts and projections.

Management reports that are not a part of the traditional financial statement disclosures will not become a standard audit disclosure due to market factors. A regulatory authority, principally the SEC, must require that management provide reports of a nontraditional nature. The next step would be the development of accountability standards and the extension of the attest function.

An example of this process is management's report on internal control. For more than a decade auditors, regulators, and legislators have advocated a report on internal control as a vital management accountability. Managers of corporations have not responded by voluntarily reporting on internal controls, and the accounting profession has not had authority to require such a report. Adoption of the SEC's 1988 rule proposal, "Report of Management's Responsibilities," will be necessary before it becomes a standard report. If the attest function is extended to add credibility to this management report, the standard audit report will include this change in auditor performance [Solomon, 1990].

SUMMARY AND CONCLUSION

The accounting profession has historically communicated the nature of its audit work to the public in a relatively brief statement. The auditor's standard short form report developed its form originally from the practice in the British system. One critical element, authority, was missing. The audit in the United States was not required by the capital markets or by law. The events of the 1929 stock market crash and the depression years of the 1930s significantly altered the economic, social, and political environment of the accounting profession and auditing practice. Legislation and stock exchanges began to require audits, and accounting practice began to establish standards. The standard short form report was developed and subsequently expanded to describe the work and assurance of the auditor. Since the last version of the report in 1948, attention has focused on the adequacy of the auditing function as it is practiced and described in the auditor's report. This attention has been manifested in Congressional investigations, investigations directed by the profession, the SEC's oversight activities, legislation, and litigation. These events have revealed the significant disparity between what the public seems to expect from an audit, on the one hand, and what auditors have believed could reasonably be accomplished in an audit and were willing to represent in the audit report, on the other hand. The users of audit reports have remained steadfast in the expectation that the auditor's work provided greater assurance than auditors believed that they were representing. If this disparity, commonly referred to as "the expectations gap," were to be closed or at least reduced, the accounting profession needed to take the initiative.

In addressing the challenge of closing the gap, the accounting profession has rewritten the standard short form audit report. Although the icon of brevity was not abandoned, the report is the most significant modification and expansion of terms to describe the responsibilities, work, and assurances of the auditor since 1934. Concepts that had been assumed or were implied in the old version of the report were explicitly stated, and concepts that had always been expressed were given renewed expression and emphasis.

The new audit report is not simply reflective of semantic changes, but a new effort to describe the auditor's work. The new report also describes substantive changes that clearly indicate that the accounting profession is not waiting for the expectations of the public to change. In particular, the report recognizes the importance that the public places on fraud detection. Other "expectation gap" SAS's *(No. 53, No. 54, No. 55)* also reflect acknowledgment of the auditor's responsibility to detect material misstatement in the financial statements of management.

Further evidence that public expectations are gaining recognition may be found in the requirements of *SAS No. 59*, an expectation gap statement, which extends the auditor's work beyond the traditional scope of responsibility by requiring a report on any uncertainties about an entity's ability to continue as a going concern. This new standard is, in effect, acquiescing to the criticism that auditors have been too concerned about the numbers reported and not about what they mean. The public would like more interpretation of the financial data [Olson, 1977].

If the public's needs and expectations continue to be accommodated, additional management accountabilities will be reported. Because of the unique qualities of independence and credibility, the auditor will have an opportunity to expand the audit function and reporting, even to management accountabilities that do not fit into the traditional historical financial statement and footnote structure. Dicksee [1915], perhaps the most influential nineteenth century accountant, expressed a principle for the development of the profession that is as relevant today as it was 75 years ago.

> If it should be thought that the standard that I have throughout advocated is somewhat Utopian in character, and unattainable in practice, I can only reply that . . . an incomplete investigation seems worse than useless, and I am convinced that it is only by voluntarily accepting, and even increasing, the responsibilities of our position that we can hope to maintain and to increase the large measure of public confidence we at present enjoy.

The profession must maintain and increase public confidence by eliminating the expectations gap. The new auditor's report is a significant initiative that will be carefully observed to see if it will begin to close the gap.

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