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The Audit Report Is Not Understood By Investors

The Form And Terminology Of The Report Should Be Changed

By Andrew H. Barnett, DBA

The recommendation of the AICPA's Commission on Auditor's Responsibilities (Cohen Commission) for significant revision in the auditor's report represents the most ambitious attempt to improve the communicative effectiveness of the auditor in over a quarter century. This article presents the results of an empirical study which partially supports the Commission's recommendations and provides insight that may increase the effectiveness of the report as a communication medium.

A questionnaire survey was conducted of professional and non-professional investors with the primary objective of measuring their understanding of the standard short-form unqualified audit report currently in use¹. Investors' responses to each questionnaire item were analyzed to identify the meanings they assign to specific audit report terms and concepts. After a description of the nature of the survey, the results will be analyzed and the Cohen Commission's conclusions will be evaluated in view of those results.

The Survey

A questionnaire was sent to a sample of professional and non-professional investors who reside in

Texas. The sample was randomly selected from a list containing approximately 47,000 investors. A total of 288 usable responses were received representing a response rate of 46 percent. One hundred eleven respondents were professional investors and 177 were non-professionals.

The Respondent Profiled

Since the survey respondents included only Texas residents, a comparison of a profile of these respondents with information about all U.S. investors is useful as a frame of reference for discussion of the results. Compared to a 1974 Arthur Andersen & Company study [1974, p. XIV.] of a representative sample of U.S. shareholders, the Texas investors included in this study

1. are somewhat older (89 percent are over forty, vs. 78 percent); and,
2. are more highly educated (83 percent have a bachelors degree or higher vs. only 41 percent).

Furthermore, compared to a 1970 New York Stock Exchange study of U.S. shareholders, the Texas investors

1. are also older (an average of 53, vs. 47);
2. also have more education (only

36 percent of the U.S. group have at least a bachelors degree); and;

3. have much more money invested in stocks. (A majority have over \$50,000 invested, while a majority of U.S. investors had less than \$10,000.)

Additional characteristics of the typical respondent are noteworthy. The person considers the annual report as the most useful source of information for investment decisions and looks at the auditor's report included in annual reports of prospective investees before making an investment decision.

The Questionnaire

The questionnaire was pretested to improve its validity and reliability as a measure of investors' audit report knowledge. Fifteen questions were included in the questionnaire, using the following three selection criteria: (1) each of the items should require that respondents demonstrate their knowledge of terms or concepts useful to the overall understanding of the auditor's report; (2) the correctness of the keyed correct answer should be verifiable by reference to authoritative literature; and, (3) the breadth of the items should allow testing of all overall knowledge of audit report terms and concepts, while permitting the respondent to complete the entire questionnaire in 30 minutes. Of the fifteen items, seven addressed the meaning of selected audit report terms, four concerned the auditor's role and responsibility, and four dealt with relevant concepts not explicitly addressed in the report. The questionnaire also included a sample audit report so that all respondents would have an identical frame of reference.

Results of the Study

Table 1 contains the percentage frequency of investors' responses to each of the fifteen multiple choice questions. For each question, the correct choice is indicated, the content of the question is presented, and the percentage of each investor group responding to each answer choice is provided. The total of these percentages approximates 100 percent for each question; any difference is due to rounding error. Some condensation of the questions has been made in the interest of conciseness, but the substance of the question has not been affected.

TABLE 1
PERCENTAGE OF RESPONSES BY INVESTOR CATEGORY,
i.e., NONPROFESSIONAL INVESTOR (NON) AND
PROFESSIONAL INVESTOR (PRO)

Correct Response Is Circled	Question and Choices	Non ^a	Pro ^b
1.	The auditor's opinion means that the auditor has made which one of the following conclusions?		
	A. That the statements are accurate and precise.	12.4	16.4
	<input checked="" type="radio"/> B. That the principles on which the statements are based are those which either best reflect the circumstances or are at least selected from among generally acceptable alternatives.	49.2	50.2
	C. That the principles on which the statements are based represent those principles which best reflect the circumstances.	27.7	29.1
	D. None of the above.	8.5	4.5
	E. Don't know.	2.3	—
2.	Who is primarily responsible for assessing the fairness of statements which have been audited?		
	<input checked="" type="radio"/> A. Management.	41.2	50.9
	B. Auditor.	46.9	45.5
	C. Stockholders of the company.	7.9	2.7
	D. None of the above.	1.7	.9
	E. Don't know.	2.3	—
3.	The auditor's report usually covers which of the following:		
	A. All financial information in the company's annual report, including financial statements, management's summary of operations, and financial information in the president's letter.	21.5	21.8
	B. Only the financial statements, excluding the notes.	2.8	2.7
	<input checked="" type="radio"/> C. Only the statements specifically mentioned in the report, including the notes.	72.3	75.5
	D. None of the above.	1.1	—
	E. Don't know.	2.3	—
4.	Which one of the following describes the meaning of the term "tests" as used in the auditor's report?		
	<input checked="" type="radio"/> A. The audit procedure of selecting for examination a sample of the records and other evidence, as opposed to examining all of the records and evidence.	79.1	76.4
	B. The audit procedure used to verify the mathematical accuracy of the records.	2.8	6.4
	C. The audit procedure of examining all accounts.	11.9	12.7
	D. None of the above.	1.1	.9
	E. Don't know.	5.1	3.6
5.	The clause "present fairly . . . in conformity with generally accepted accounting principles" means that:		
	A. In the auditor's opinion, the financial statements are presented in accordance with GAAP, therefore, the presentation is fair.	19.2	10.9
	B. The presentation is in accordance with GAAP and the presentation is fair.	34.5	30.9
	<input checked="" type="radio"/> C. The presentation is in accordance with GAAP and the accounting principles have been applied fairly.	43.5	55.5
	D. None of the above.	1.1	.9
	E. Don't know.	1.7	1.8
6.	Which one of the following describes the relationship between "examination" and "audit"?		
	A. "Examination" means the same as "audit."	33.9	33.6
	<input checked="" type="radio"/> B. "Examination" implies a more detailed and more extensive investigation than "audit."	14.7	20.0

Each of the items should require that respondents demonstrate their knowledge of terms or concepts useful to the overall understanding of the auditor's report

Adequacy of Investors' Report Knowledge

An analysis of Table 1 suggests that the overall level of audit report knowledge of both professional and nonprofessional investors may be inadequate. While the minimum satisfactory knowledge level is subject to debate, some presumed level is useful to this analysis. Using 65 percent as a conservative minimum acceptable knowledge level, it can be observed that nonprofessional investors demonstrated adequate understanding with respect to four of the fifteen questions; and professionals, with respect to only three: 65 percent or more nonprofessionals correctly answered questions three, four, eight, and thirteen; and, 65 percent or more professionals correctly answered questions three, four, and eight. The two groups demonstrated surprising homogeneity. With the exception of question thirteen, acceptable performance was demonstrated on identical questions. Even for question thirteen, the correct response percentages differed by less than four percentage points.

With respect to overall knowledge adequacy, the performance of both investor groups could be characterized as equally inadequate. The average nonprofessional investor could answer only 50 percent of the questions correctly, while the average professional investor could answer only 51 percent correctly. The difference between the correct response percentages of the two groups is not statistically significant (prob. = .01).

By categorizing the fifteen test questions according to the three subject areas identified in a previous section, insight can be provided about specific areas of communication breakdown. This is the subject of the next section.

With respect to overall knowledge adequacy both investor groups could be characterized as equally inadequate.

Specific Areas of Investors' Audit Report Understanding and Misunderstanding

The audit report can be characterized as an attempt to convey to users the nature and purpose of the auditors' examination of financial statements and their conclusions about the extent to which the statements are in compliance with established quality criteria. Auditors need to know the extent to which intended users understand the nature of their examination and the quality criteria used. Specifically, auditors need to know whether users assign the same meanings to report terms and concepts when interpreting it as auditors do when they write it. In addition, the report does not explicitly address certain relevant aspects of the scope of the auditor's examination and the nature of his opinion. The justification for exclusion of these aspects from the report must be that users possess a level of understanding that precludes the need for explicitly discussing these aspects. Consequently, user knowledge requirements with respect to the audit report, if the report is to be an effective medium of communication, can be summarized as follows:

1. Users must know the meaning of technical report terminology;
2. Users must understand the auditor's role with respect to the financial statements being audited; and,
3. Users must have a certain level of prior knowledge of those concepts that are not specifically discussed in the audit report.

The questionnaire included three question categories that correspond to the three user knowledge criteria identified in the preceding paragraph. Again, these are as follows:

1. meaning of terms;
2. auditor's role and responsibility

Table 1 (continued)

	NON ^a	PRO ^b
C. "Examination" implies a less detailed and less extensive investigation than "audit."	43.5	40.9
D. None of the above.	2.3	2.7
E. Don't know.	5.6	2.7
7. The phrase "generally accepted accounting principles" (GAAP) appears in the second paragraph of the auditor's report. Which one of the following statements about such principles is correct?		
A. All accounting principles which are "generally accepted" have been formally adopted by an authoritative body of the accounting profession.	31.6	35.5
B. GAAP assure comparability among financial statements of different companies by permitting the use of only one method of accounting for a particular transaction.	5.1	4.5
<input checked="" type="radio"/> C. GAAP include a range of alternative practices which sometimes makes possible the use of more than one method of accounting for a particular transaction.	57.1	60.0
None of the above.	.6	—
E. Don't know.	5.6	—
8. Which one of the following financial statements represents a presentation of financial position?		
<input checked="" type="radio"/> A. Income statement.	1.1	1.8
B. Balance sheet.	76.3	75.5
C. Statement of changes in financial position.	13.6	11.8
D. None of the above.	5.6	8.2
E. Don't know.	3.4	2.7
9. Generally, the date of the auditor's report coincides with which of the following?		
A. Balance sheet date.	29.4	37.3
<input checked="" type="radio"/> B. Date of completion of all important audit procedures.	31.1	28.2
C. Date of transmittal of the report to the client company.	32.8	32.7
D. None of the above	1.1	—
E. Don't know.	5.6	1.8
10. "Generally accepted auditing standards" refers to standards which have come into existence in which one of the following ways?		
<input checked="" type="radio"/> A. By being adopted and accepted by the membership of the accounting profession.	36.7	46.4
B. By being required by the FASB.	20.9	13.6
C. By their general usage over a long period of time rather than formal adoption by the profession.	34.5	30.0
D. None of the above.	.6	.9
E. Don't know.	7.3	9.1
11. In the phrase "generally accepted accounting principles," the term "principles" refers to which one of the following?		
<input checked="" type="radio"/> A. A collection of interrelated conventions, rules, concepts and standards.	41.2	32.7
B. Fundamental truths which form the theoretical foundation upon which accounting theory and practice are based.	23.7	30.9
C. General guides to accounting for business activities.	28.8	30.0
D. None of the above.	1.7	—
E. Don't know.	4.5	6.4
12. Which one of the following statements describes the auditor's responsibility with respect to events occurring between the balance sheet date and the end of his examination?		
A. He is fully responsible for such events and for applying generally accepted auditing standards through the end of his examination.	14.1	15.5

Table 1 (continued)

	NON ^a	PRO ^b
B. He has no responsibility because this period will be included in the audit of the following year.	32.8	28.2
Ⓒ. He is responsible for performing a general review of such events.	46.9	51.8
D. None of the above.	.6	.9
E. Don't know.	5.6	3.6
13. Which one of the following correctly describes the auditor's responsibility for the detection of fraud?		
A. Since compliance with generally accepted auditing standards should result in the detection of any material fraud, the auditor is responsible for such detection.	19.2	20.9
Ⓒ. Since compliance with generally accepted auditing standards will not necessarily result in the detection of material fraud, the auditor is responsible for detection of material fraud only to the extent that such detection would clearly result from compliance with auditing standards.	68.4	62.7
C. An audit in accordance with generally accepted auditing standards is designed primarily and specifically to detect any material fraud, thus the auditor is absolutely responsible for such detection.	5.6	12.7
D. None of the above.	1.1	2.7
E. Don't know.	5.6	.9
14. Which one of the following statements about auditor independence is true?		
A. The independence standard requires that the auditor be elected by the stockholders of a company, and not directly appointed by the management, to insure the auditor's independence from the company's management.	40.7	38.2
Ⓒ. The independence standard is not violated by the payment of the auditor's professional fee by the client because the auditor is engaged by the client as an independent contractor, not as an employee.	43.5	49.1
C. The independence standard allows the auditor to undertake an audit engagement and express an opinion on financial statements of a client although he is not independent, so long as he states in his report that he is not independent.	2.8	.9
D. None of the above.	7.3	5.5
E. Don't know.	5.6	6.4
15. Which one of the statements describes the effect of internal control measures on the auditor's work?		
A. The primary responsibility for the establishment of adequate measures for safeguarding assets, assuring accurate records, and encouraging adherence to policies is typically assumed by the auditor in an audit engagement.	5.1	16.4
B. While it is customary for the auditor to notify the client of any inadequacies in such measures, the measures do not have any significant effect on the auditor's selection of audit procedures.	14.1	13.6
Ⓒ. Because the auditor's selection of audit procedures depends partly upon the adequacy of such measures, the auditor must perform an investigation and evaluation of these measures.	49.7	40.9
D. If the client's measures are inadequate, the auditor must disclose this fact in his report.	20.9	17.3
E. Don't know.	10.2	11.8

^aNonprofessional investor.

^bProfessional investor.

limitations; and,

- related concepts not specifically addressed in the report.

Tables 2 and 3 contain classifications of the questions according to these three topics for nonprofessionals and professionals. Within each category, the questions are ranked from the highest to lowest percentage of respondents answering each correctly. In addition, a measure of overall performance in each category is provided by the average correct response percentage for each category.

Meaning of terms. Seven test items dealt with technical report terms. Nonprofessionals most frequently misinterpreted the meaning of the term "examination." While this term is synonymous with "audit," in the context of the report, reference to Table 1 reveals that many nonprofessionals (and professionals) believe that it implies a more extensive investigation than "audit."

Professionals most frequently misinterpreted the term "principles." Apparently, many believe that accounting principles are part of a rigorously identified set of fundamental truths, although lower-order conventions and rules are also denoted as principles.

Two terms, "test" and "financial position," are apparently adequately understood by nonprofessionals and professionals. Perhaps most significant is that the groups recognize that the auditor relies on an examination of a sampling of audit evidence and not on an exhaustive examination of all available evidence.

Not unexpectedly, the expression "present fairly . . . in conformity with GAAP" was misinterpreted by a large proportion of both investor groups. Approximately one third of both groups favored the suggestion (choice B) that the auditor must render a dual opinion on conformity with GAAP and on fairness. Such misinterpretation is not surprising. Until 1975, little effort had been made by the AICPA, to explicitly interpret the auditor's responsibilities regarding this issue. In addition, evidence exists that this attempt has not been a complete success.² Furthermore, this dual-opinion interpretation has some support in at least two legal decisions that imposed upon auditors the responsibility to exer-

cise individual judgment as to fairness where generally accepted accounting principles do not provide specific guidance.³

One interpretation of United States v. Simon, et al. (Continental Vending) is that the court required that auditors:

... must exercise individual judgment in areas in which no specific rules or prohibitions exist to determine that statements are not misleading. But [the Court of Appeals] apparently was not asking auditors to judge individual rules or prohibitions that do exist. The Court was in effect asking auditors to appraise the application of GAAP, ... but was not asking auditors to appraise presentations based on their own private standards of fairness completely apart from GAAP. [Rosenfield and Lorensen, 1974, p. 80]

In the author's opinion, the court did not require that a standard of fairness be applied separately from a standard of conformity of existing GAAP, nor did it reject GAAP and substitute fairness. In essence, it agreed with the profession's interpretation of "present fairly, ..." and, choice (C) best reflects this interpretation.

Auditor's role and responsibility.

Four questions to which the investors replied related to the nature and limitations of the auditor's role and responsibility with respect to his audit. Nonprofessionals adequately understand (1) that the audit scope is limited to financial statements that are specified and (2) the limits of auditors' responsibility for detecting fraud. It is significant, however, that about one-fifth of both groups believe that compliance with generally accepted auditing principles should result in material fraud detection.

Nonprofessionals demonstrate a marked difference in beliefs about the focus of primary responsibility for financial statement fairness. The number who believe such responsibility is the auditor's exceeds the number who believe it is management's. Professionals are also almost evenly divided on this question. Apparently, the report should contain additional clarification with respect to the division of responsibility for the statements.

TABLE 2
NONPROFESSIONAL INVESTORS' PERFORMANCE BY QUESTION CATEGORIES

Item Description by Categories	Question Number	Correct Response Percentage
Meaning of terms:		
Tests	4	79
Financial position	8	76
Generally accepted accounting principles (gaap)	7	57
Present fairly ... in conformity with gaap	5	44
Principles	11	41
Generally accepted auditing standards	10	37
Examination	6	34
Category mean		53
Auditor's role and responsibility:		
Audit report scope	3	72
Fraud detection responsibility	13	68
Independence	14	43
Primary responsibility for statement fairness	2	41
Category mean		56
Related concepts not explicitly addressed:		
Internal control significance	15	50
Nature of auditor's conclusion	1	49
Subsequent events responsibility	12	47
Significance of report date	9	31
Category mean		44

TABLE 3
PROFESSIONAL INVESTORS' PERFORMANCE BY QUESTION CATEGORIES

Item Description by Categories	Question Number	Correct Response Percentage
Meaning of terms:		
Tests	4	76
Financial position	8	76
Generally accepted accounting principles (gaap)	7	60
Present fairly ... in conformity with gaap	5	56
Generally accepted auditing standards	10	46
Examination	6	34
Principles	11	33
Category mean		54
Auditor's role and responsibility:		
Audit report scope	3	76
Fraud detection responsibility	13	63
Primary responsibility for statement fairness	2	51
Independence	14	49
Category mean		60
Related concepts not specifically addressed:		
Subsequent events responsibility	12	52
Nature of auditor's conclusion	1	50
Internal control significance	15	41
Significance of report date	9	28
Category mean		43

Implicit report concepts. The final category contains four questions about selected concepts not explicit in the report. If one accepts the premise that the four selected concepts are relevant, it follows that their exclusion is based on the presumption that users already understand them and an explanation is not necessary. This presumption is apparently incorrect, however. None of these concepts were adequately understood. And, the category mean for these is substantially lower than that for the other two categories.

The Cohen Commission discussed many of the communicative aspects of the report addressed in this survey, along with others. The following section discusses the implications of the results of this study for the Commission's recommendations.

Implications for Cohen Commission Recommendations

In its report, the Commission cited four communicative deficiencies of the present audit report for which the results of this study have particular relevance. One deficiency mentioned is that the lack of explicit discussion of certain intended messages in the report necessitates reader inferences that may be unwarranted. An example specified by the Commission is the absence of a clear explanation that financial statements are the representations of management. This is the most plausible explanation for the fact that 47 percent of the nonprofessional investors assign primary financial statement responsibility to *auditors* while only 41 percent, to management. Additional empirical support for this alleged deficiency is provided by the investors' apparent confusion about auditor independence; only 44 percent of the nonprofessionals believe that the payment of the audit fee by the client does not violate the independence standard.

Another deficiency of the report that is cited by the Commission is the assignment of technical meanings to words that have different meanings in common usage. In essence, such practice is an attempt to change widely accepted language norms rather than operate within them. It would be much easier to employ terminology with recognized meanings

It would be much easier to employ terminology with recognized meanings rather than to attempt to create in the minds of users new meanings for old words

rather than to attempt to create in the minds of users new meanings for old words. One-way communication with widely dispersed receivers is tenuous at best, without complication by technical meaning assignments. The survey results evidence the futility of this practice. Five of seven report terms and phrases were misunderstood by an unacceptable proportion of the respondents, including "GAAP," "present fairly . . . in conformity with GAAP," "principles," "generally accepted auditing standards," and "examination."

A third criticism of the Commission is that the report does not include discussion of auditors' responsibilities that have been clarified or expanded subsequent to the last substantial revision. The respondents demonstrated greater misunderstanding of the four implicit report concepts as a group than to any of the other categories addressed in the survey. One example that the Commission gave was addressed in this study. It related to the auditor's subsequent events responsibility. As shown in Table 1, approximately 30 percent of the investors believed auditors have no responsibility, while approximately 50 percent correctly described their responsibility.

Finally, the Commission discussed another deficiency to which the empirical insight gained herein is relevant. The suggestion is made that the standardization of the audit report has conditioned readers to assign a meaning to the report *form* instead of, or in addition to, constituent terminology. In the process of being conditioned to assign a meaning to message form, users must first assign a meaning to the terminology. If they initially misinterpret the meaning of that terminology, they will also misinterpret the meaning of the form of the report.

The empirical evidence herein suggests that users assign unintended meanings to the terminology

of the audit report. Unintended meaning is, undoubtedly, also being assigned to the report form. Furthermore, through a conditioning process, it is being engrained in the minds of users from the force of habit. The correct users' misunderstandings of the audit function without changing both the terminology and form of the audit report would be very difficult. Consequently, a revision of the report may be unavoidable if the effectiveness of communication with users is to be significantly improved. Ω

NOTES

¹For purposes of this study, professional investors are defined as those persons who invest or give investment advice as part of their employment; nonprofessional investors are those who are not employed to invest or advise.

²The Auditing Standards Executive Committee, in *Statement on Auditing Standards No. 5*, attempted to clarify the meaning of "present fairly." However, Kenneth I. Solomon, a member of the Committee, objected to paragraph nine of the statement because of his belief that it imposes an independent fairness standard. Additionally, J. Herman Brasseur, another member, dissented to the statement because he believed that it failed to alleviate the differences in conflicting interpretations. See Auditing Standards Executive Committee, *Statement on Auditing Standards No. 5*, p. 5.

³*United States v. Simon, et al.*, 425 F.2d (2nd Cir. 1969); and, *Herzfeld v. Lavenhol, Krekstein, Horwath and Horwath*, CCH Fed. Sec. L. Rep. 94, 574 (S.D.N.Y. 1974).

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