AUDITING THE AUDIT REPORTS

FAYETTEVILLE, Ark. – Before lawmakers rush to respond to recent corporate scandals by changing audit regulations, University of Arkansas researcher Willie Gist thinks they need to realize that the existing standards are not the problem.

“In spite of the scandals, nothing has happened to say that the standards themselves don’t work,” explained Gist, whose research focuses on financial audits. “Before we rush forward with legislation, we need to ask: What are you going to do differently? What are you going to regulate?”

Gist recently completed a study of the policy process in which audit rules and reports are developed and found that regulators do not favor audit firms over report users. He looked at the expectations gap, which is the difference between what users of the financial report expect it is providing and what auditors reasonably expect to give.

“The expectations gap has been a big issue in auditing for a long time,” explained Gist, associate professor of accounting in the Sam M. Walton College of Business. “We examined perceptions of and preferences for the new Auditor’s Standard Report, which was developed in part to close the expectations gap, to see if it favored the auditing firms or the users of the report.”
Gist presented his findings recently at the international Symposium on Audit Research in Sydney, Australia. He conducted his study along with Darryl Wilson, assistant professor of information systems in the Walton College; Bart Ward, dean of the Meinders School of Business at Oklahoma City University; and Trimbak Shastri of the University of Louisville.

The Auditor’s Standard (Unqualified) Report is the most common report issued by auditing firms. It concludes with an Opinion Paragraph in which the auditors state their assessment that the financial statements are fairly presented in accordance with generally accepted accounting principles. During an audit, the auditors obtain certain written representations from company management pertaining to the financial statements, which are kept in the working papers. They also apply audit procedures to sampled transactions and accounts in order to gather sufficient evidence to support the opinion.

“Of course, auditors are free to review any transactions or accounts that might seem inconsistent. Generally, if auditors find something questionable, they bring it to the attention of the company’s management and corrective action is taken before the report is issued, so the Standard (Unqualified) Report is most common,” Gist explained. “However, there are a number of other report types. For example, auditors might issue a Qualified Report if they find a departure from standard accounting practice or if the client prevents the auditor from conducting a complete audit.”

The Auditing Standards Board (ASB), which is a regulatory body of the American Institute of Certified Public Accountants (AICPA), determines the wording of audit reports. Since auditors are self-regulated, the researchers wanted to know if the wording of the auditor’s report favored the auditors over the users. The researchers theorized that the reports might be relatively more beneficial to the accountants and auditors than to the consumers/users of the report. They began by reviewing the ASB’s deliberations that led to the 1988 change in reporting format.

In 1988 the ASB replaced the two-paragraph standard report (SR) that had been in use since the 1950s with a more detailed, three-paragraph standard report (NSR). The researchers compared these two reports and a third modified report (MSR), which made reference to the auditor’s responsibility for detection of fraud, to determine which one was most useful to auditors and report users, like bank lending officers, financial analysts and investors. Participants in the study included 123 bank officers and financial analysts, representing the users, and 122
audit partners and managers of certified public accounting (CPA) firms, representing the auditors.

Each study participant was given some background information on a hypothetical company and one Auditor’s Standard Report. They were then asked to respond to 14 case questions designed to gauge the credibility and perceived risk conveyed by the report. The researchers found that, although the users generally preferred the MSR, both users and auditors considered the NSR, which is currently in use, to be a substantial improvement over the SR format.

“The evidence suggests that the ASB is influenced by public comments and that it does consider the cost and benefits of its policy decisions for users as well as for auditors,” Gist said.

Gist believes that the ASB remains in the best position to police the profession. Pointing out that the Security Exchange Commission has always had the authority to regulate financial accounting and disclosures of publicly held companies and oversee the auditing profession, Gist notes that the existing audit format already requires management to sign off on the accuracy of their data. "The first paragraph of the Auditor’s Report, clearly states that these financial statements are the responsibility of the Company’s management. I don’t see how adding another signature line is going to make that any clearer," he added.