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The Evolution of Audit Reporting

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Words are, of course, the most powerful drug used by mankind.
—Rudyard Kipling

The words the auditor dispenses are a powerful drug. They influence resource allocation in our society. Thus, the auditor's report represents a drug that should be dispensed and used with great care. Its purpose and limitations should be understood by users and they should be made aware of undesirable side effects and the dangers of misuse.

Like all drugs the auditor's report should be subjected to continuous scrutiny to evaluate its effectiveness over time. Perhaps steady use creates a tolerance that reduces the report's potency. Perhaps it has uses beyond its primary purpose.

Indeed the auditor's report has been evaluated and revised. Since the first authoritative guidance for audit report wording was given in 1917, the report has been revised seven times. This represents, on the average, a revision every 10.6 years. Averages are deceiving, however. The last revision occurred 33 years ago in 1949. What this statistic tells us is the report revision occurred much more frequently in the early days of the profession and much less frequently as the profession matured. A crucial question is why.

The auditor's report also has been used for purposes other than to assist in the allocation of resources. The report has been used to stimulate change in professional practice and to influence the auditor's legal liability. A crucial question is how, if at all, these ancillary uses have affected the primary use.

This paper traces the evolution of audit reporting in the United States and identifies the major forms of the auditor's standard report and the pivotal events and circumstances leading to the development of those reports. It also explains the evolutionary process that has shaped present reporting practice, created reporting controversies, and that may influence future reporting developments. The paper is organized around what we consider to be the landmarks in audit report evolution, with discussion of what we consider to be the primary environmental influences leading to the landmarks.

Landmark I—1917 Federal Reserve Bulletin

Until 1917 there were no authoritative accounting or auditing standards established in the United States. In addition, no generally recognized standards

had evolved from professional organizations, statutory requirements, or litigation. The lack of defined responsibilities applicable to the American auditor resulted in a diversity of audit reporting practices.

Since the profession of accounting was introduced to the United States by British accountants, the report form used in England formed a basis for American auditors' reports. Although there was no predominant report form, an example of a typical "certificate" of the early days is one given by Price Waterhouse & Co. on St. Louis Breweries Ltd.

> We have examined the above accounts with the books and vouchers of the company, and find the same to be correct. We approve and certify that the above balance sheet correctly sets forth the position of the company.

The flexibility in reporting permitted by the lack of defined standards was accentuated by the service-to-the-client philosophy that pervaded early accounting practice. In the absence of statutory requirements for an audit, early practitioners of public accounting had to justify engagements on the basis of economic benefits to the client. Since clients did not have to have audits, an auditor was not in a position to dictate the extent of work that a client required. The scope of the examination was flexible, but the auditor would, accordingly, restrict the report wording to conclusions justified by the scope of the work performed.

Inadequate financial reports and unsatisfactory audits were not uncommon. Without authoritative guidelines, without control over the admission standards of its members, and without disciplinary authority there was little control over the quality of accounting or auditing. The financial panic of 1907 discredited big business in the eyes of the public and created a political environment favorable to government regulation.

The legislation that created the Federal Reserve Board (FRB) in 1913 and the Federal Trade Commission (FTC) in 1914 was of overriding importance to the profession. The formation of these regulatory agencies started a movement that fostered standardization of auditors' reports.

Both the FTC and the FRB shared a dissatisfaction with financial statements audited by public accountants. The chairman of the FTC suggested three steps to improve audited financial statements:

- The American Institute of Accountants (AIA) should formulate uniform guidelines expressing its judgment as to how alternative accounting principles should be handled.
- The FTC should develop a register of accountants acceptable to the FTC and the FRB.
- The AIA should exercise greater disciplinary control over public accountants.

To avoid political control of the profession, the AIA, through its committee on federal legislation, conferred with the FTC and the FRB. The committee successfully argued that it could provide guidelines for the conduct of independent audits that would overcome the FTC's concerns. The committee also persuaded the agencies that it could exercise control over its admission

requirements and the ethical conduct of its members, thus precluding the need for a federal register of accountants. Finally, the committee suggested that the FRB might recommend and give preference to commercial paper accompanied by balance sheets "certified" by professional accountants. As a result of these discussions came the first authoritative guide for the conduct of independent audits, the Federal Reserve Bulletin of 1917, "Uniform Accounting."[1]

The committee seems to have taken advantage of the confusion between uniform accounting and standard audit requirements. The Federal Reserve Bulletin mixed the two concepts. The preface said "The following tentative proposal for a uniform system of accounting to be adopted by manufacturing and merchandising concerns . . . . is now reprinted for more general distribution."[2] However, the text of the bulletin consisted mainly of recommended audit procedures. Literally, the publication had nothing to do with uniform accounting systems.

The bulletin concluded with a suggested form of auditor's report, marking the first way station in the evolution of auditors' standard reports.

> I have audited the 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 . . . and the results of its operations for the period.[3]

The reference to "accounts" in the report and the term "certify" likely stemmed from the influence of the English report form. The term "opinion" was also used, however, suggesting that certify may not have been intended to connote as factual a representation as the literal meaning of the word suggests. The reference to the FRB plan communicates adherence to a set of specific guidelines and thus adds credibility to the statements.

This report was by no means in general use. Report wording varied and included as alternatives to "in my opinion" such phrases as "correctly set forth," "exhibit a true and correct view," "accurately record conditions," and "represent the true financial position."

Although the recommended report was not a "standard" report in the sense that it was required by an authoritative pronouncement, it was the first report to emerge from the deliberations of the AIA and be recommended in a widely circulated publication. Thus it marked the beginning of a series of recommended reports that would ultimately lead to a "standard" report.

Although it must be conceded that the initial effort to recommend a report form was partly in response to outside pressure, the Federal Reserve Bulletin of 1917 marked the beginning of the profession's exercise of self-discipline over the content of the auditor's report. The profession's initiative in response to outside pressure resulted in the first landmark in the evolution of the auditor's standard report.

Landmark II—1929 Revision of the Federal Reserve Bulletin

The march toward a standard report continued with the publication of a revised edition of the 1917 Federal Reserve Bulletin in 1929. The revision was

initiated by a special committee of the AIA in 1928, prior to the stock market crash, in recognition of the commercial growth and prosperity characterized by industrial expansion, issuance of new securities, purchases, mergers and the accompanying growth in the variety and complexity of financial reporting practices.

The 1929 revision, titled "Verification of Financial Statements,"[4] expressed concern that the 1917 bulletin might have failed to make clear that an audit was not a complete examination of the details underlying financial statements. Dispelling this notion was important to the profession. The increasing size of businesses and the growing volume of their transactions virtually demanded testing in an audit. The new bulletin stressed that the auditor used tests instead of detailed verification when reliable controls existed even though the link between control strengths and audit procedures was not well established in practice. The revision suggested a report form, still referred to as a certificate, that read 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.[5]

Although the 1929 bulletin emphasized testing in an audit, the suggested report did not refer to testing or the use of auditor judgment. The major difference between the 1929 and 1917 reports was the deletion of the references to the "plan suggested and advised by the Federal Reserve Board" and the "correctness" of the financial statements. In addition, the suggested report was divided into two paragraphs that parallel the scope and opinion paragraphs of the current standard report.

Landmark III—The Ultramares Case

The Ultramares decision erased what accountants had previously considered to be a clean line between negligence and fraud.[6] In substance the decision held that accountants could be liable to third parties for gross negligence from which an inference of fraud could be drawn.

The Ultramares case caused the accounting profession to rethink its reporting practices. An editorial in the July, 1931 *Journal of Accountancy* offered recommendations for auditors' reports based on the Ultramares decision.

> Every accountant's report will be addressed to the client only . . . the accountant will divide his report into two sections, one dealing with fact (that is, scope of examination) and one with opinion.
>
> . . . The accountant perhaps should abandon certificates and merely make reports . . . The word "certify" which has been used for many years is quite inappropriate and should be abandoned . . . It is absurd to speak of certifying an opinion.[7]

Faced with the potential expansion of liability to third parties, accountants began to follow the suggestions in the editorial. The word "certify" began to

disappear from reports to make clear that the report was an opinion and not a guarantee. The typical report read:

> We have examined the accounts of . . . for the year ended . . . In our opinion the accompanying balance sheet and statement of profit and loss set forth the financial condition of the company at . . . and the results of its operations for the year then ended that date.

The suggested report revisions illustrate the use of the report as an instrument of change. Removal of the term "certify" and emphasis on the auditor's conclusion as an opinion preceded widespread acceptance of those practices. Thus, the report itself was used to introduce specific changes before those changes were readily accepted by practitioners, let alone the public.

Landmark IV—Correspondence with the Stock Exchange

The financial reporting abuses that led to the stock market crash in 1929 had not gone unrecognized by thoughtful members of the accounting profession. As early as 1927, the Institute attempted to establish cooperative relations with the New York Stock Exchange (NYSE) to improve financial reporting practices. However, it took the catastrophic market crash in the fall of 1929 to excite the exchange's interest in financial reporting reforms and cooperation with accountants.

Late in 1930 a special Institute committee on cooperation with stock exchanges was formed. The committee undertook two major tasks: (1) to educate the public in regard to the significance of financial statements, their value and unavoidable limitations, and (2) to make the financial statements published by corporations more informative and authoritative.

One of the committee's major recommendations aimed at achieving these objectives was to require listed companies to adhere to broad, generally accepted accounting principles within which they could select detailed methods of accounting best suited to their requirements. Companies would be required to disclose the methods employed to enable an investor to judge the degree of conformity to standard usage. The companies also would be required to consistently apply the adopted methods.

The committee also sought to define the auditor's responsibility for financial statements prepared under these new accounting guidelines. It recommended that the auditor's report specifically state whether the financial statements were prepared on the basis of the accounting methods adopted and disclosed by the company.

The committee's recommendations were approved by the NYSE with one critical exception. It was not considered necessary or feasible for companies to disclose the detailed accounting methods used so that users could judge the conformity of the company's accounting methods with the broad, generally accepted accounting principles the committee established. Instead, this responsibility was shifted from the user to the auditor by requiring the auditor's report to state whether the company was following these broad principles.

In January, 1934, the Institute published a pamphlet titled "Audits of Corporate Accounts" that contained the correspondence between the Institute's committee and the Committee on Stock List of the Exchange. This

pamphlet resulted in an evolutionary leap in audit report structure that distilled and introduced major reporting responsibilities that would not be formally recognized in auditing standards for another 15 years.

These responsibilities are highlighted in the recommended report form.

> We have made an examination of the balance sheet of the XYZ Company as at 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 statements 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.[8]

This report was in marked contrast to its predecessors. For the first time, the report referred to the financial statements as the object of examination rather than books or accounts. The concept of testing was explicitly mentioned in the report and additional detail concerning the scope of the audit was included.

The opinion paragraph continued to emphasize that an opinion rather than a guarantee was being given. This paragraph also introduced the concept of accepted accounting principles as a standard against which fair presentation could be measured. In fact, the report would seem to resolve the rather recent debate over the meaning of the phrase "present fairly in conformity with generally accepted accounting principles." In the above report it is clear that the phrase "in accordance with accepted principles of accounting" modifies the term "fairly present," indicating that the committee was unwilling to use the phrase "fairly present" alone. This lends historical legitimacy to the contention that the phrase "present fairly in conformity with generally accepted accounting principles" in the current standard report defines a single standard for judging accounting presentations.

The opinion paragraph also introduced a reference to consistency. Since the adopted accounting methods were to be consistently applied under the NYSE requirements, the auditor was given responsibility for reporting on adherence to this requirement.

Another significant accomplishment of the Institute's committee was the recommendation that the new form of report be adopted as a "standard" report. The committee recognized a need for uniformity in the language of the auditor's report. This uniformity was intended to accomplish two objectives: (1) give a definite form to audit report language among audit firms, making the reports comparable and reducing the possibility for misunderstanding arising from vagaries in report wording, and (2) make qualifications in audit reports more easily recognizable.

The publication of "Audits of Corporate Accounts" exemplified the profession's desire and ability to exercise initiative in improving financial

reporting and auditing. Although the pamphlet's requirements could only be enforced by the NYSE against listed companies and their auditors, it became apparent that the financial statements and auditors' reports of unlisted companies might be considered deficient unless the requirements had been met. Thus, the audit report continued to be used as a force for change in professional practice. The standard wording tended to be used in all audit engagements

Landmark V—The Securities Acts and McKesson & Robbins

The efforts of the AIA and the NYSE during the 1932-1934 correspondence occurred in an environment of severe public criticism of the financial community and corporate management. In response to this concern the Congress passed a series of securities acts and created the Securities and Exchange Commission (SEC) to administer them. The acts placed a new and substantial responsibility on the accounting profession from both the standpoint of increased legal liability and from the need to improve professional standards for both accounting and auditing.

Although the SEC was vested with the authority to prescribe accounting principles and the form and content of the auditor's report, it decided, partly due to the persuasiveness of Institute representatives, to leave the initiative to the profession. The SEC declined to prescribe the exact form of the auditor's report: "Instead we ask for a certificate that shall be illuminating both as to the scope of the audit and the quality of the accounting principles employed by the registrant."[9]

As part of its efforts to take the initiative in developing accounting and auditing standards, the Institute revised the Federal Reserve Bulletin in 1936. Although the bulletin expanded the discussion of internal control and its relation to audit tests, no revision in the suggested form of report was made.

Practicing accountants had just begun to implement the guidance in the revised bulletin when the McKesson & Robbins fraud surfaced. The SEC held hearings to (1) determine the detail and scope of the audit conducted, (2) the extent to which the prevailing standards of audit procedure had been followed, and (3) the adequacy of accepted auditing procedures. One outcome of this inquiry was an AIA requirement for confirmation of receivables and observation of physical inventory taking.

The SEC's report was not released until 1940 and by that time the AIA had adopted modifications of several positions taken in the 1936 bulletin. The modifications were published in a pamphlet titled "Extensions of Auditing Procedure" which was reissued as the first of a series of Statements on Auditing Procedure (SAP No. 1) to be issued by the Institute.

The new statement, recognizing the results of the SEC's investigation, modified the auditor's standard report as follows:

> We have examined the balance sheet of the ABC Company as of December 31, 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 ABC Company at December 31, 1939, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.[10]

The substantive changes in the new report were in the scope paragraph. However, what was intended as an editorial improvement in the opinion paragraph would later prove to be a major subject of debate within the profession.

The scope paragraph revision emphasized review of internal control as an essential element in the audit and implicitly justified the auditor's reliance on the system in lieu of detailed testing. This reference to internal control preceded any widespread use of control strengths to reduce the extent of testing. The new report wording acted as a catalyst to modify practice just as much as it informed readers about an audit characteristic. In addition, the concept of professional judgment was made explicit in the scope paragraph by reference to the gathering of evidence by the auditing "methods" and extent of testing deemed appropriate.

The opinion paragraph revision transposed the words "fairly" and "present" and separated "in conformity with GAAP" from "present fairly." The reason for repositioning the reference to GAAP was to clarify the meaning of the consistency reference. Some accountants apparently believed that "consistently maintained during the year," in the previous report, did not relate the principles for the current year to those for the prior year. The changed wording removed that confusion, but clouded the relationship between fair presentation and GAAP.

The issuance of SAP 1 also introduced a new report category: the withheld opinion. Prior to SAP 1 it was a common reporting practice to specify the accounting deficiencies, omission of audit procedures or other similar limitations in the auditor's report and then introduce the final expression of opinion with wording such as "subject to the foregoing." The report thus left to third parties the decision as to what extent they could rely on the financial statements as a whole.

With the issuance of SAP 1, accountants were prohibited from rendering an opinion on financial statements, taken as a whole, when the deficiencies in the statements or the limitations on the scope of their engagement would not warrant such an opinion. SAP 1 purged from practice the type of report in which the auditor expressed an opinion on the financial statements after stating all the exceptions and limitations under which the opinion was expressed by requiring the following:

> The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when his examination has been less in scope than he considered necessary.[11]

SAP 1 did not, however, preclude the type of report in which the CPA indicated the extent of work performed and the findings as a result of that work. In fact, the statement explicitly recognized this type of report by stating that under the circumstances of a limited scope engagement:

> . . . the independent certified public accountant should limit his report to a statement of his findings and, if appropriate, his reasons for omitting an expression of opinion.[12]

The phrase "if appropriate" permitted the auditor to issue a report that neither expressed an opinion nor disclaimed one.

Landmark VI—The Introduction of GAAS

The McKesson case had focused the attention of the SEC on auditing more sharply than before. In a 1939 speech before the Institute's annual meeting, William Werntz, the chief accountant, noted:

> In contrast to the time we have spent on accounting principles, there have been few cases before us involving the question of whether a reasonable audit was made.

He then went on to discuss the underlying concepts of independent auditing, including the qualifications of the auditor, such as independence, the relative responsibility of management and the auditor for financial statements, and reliance on internal control.

The Committee on Auditing Procedure consulted with the SEC and agreed that a distinction should be made between auditing standards and the procedures necessary to meet those standards. It was believed that SAPs contained both standards and procedures but that the distinction had not been clearly drawn.

The committee immediately began work on a statement of formal auditing standards. However, the committee's work was interrupted by the demands made on the profession by World War II and the effort to establish standards was not renewed until 1947.

Meanwhile, in 1941, the SEC amended Regulation S-X by requiring changes in the auditor's report, one of which was a statement as to whether "the audit was made in accordance with generally accepted auditing standards applicable in the circumstances." Consequently the Institute recommended adding the following words to the scope paragraph in the auditor's report:

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

Thus, the reference to generally accepted auditing standards appeared in the auditor's report eight years before the Institute formally adopted them. Since the reference to GAAS preceded any extensive development of the written expression of these standards, the report wording served to spur that development.

Shortly after the addition was made to the report, it was recognized that, since auditing standards were of general application, the phrase "applicable in

the circumstances" was inappropriate in this context. Accordingly, this sentence was changed to read:

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

In 1948, after years of experience and after the Institute membership had formally adopted auditing standards, a further revision of the report was approved as follows:

> We have examined the balance sheet of ABC Company as of December 31, 1949, 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 financial position of ABC Company at December 31, 1949, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.[13]

The major distinction between this report and its predecessor was the omission of the reference to reliance on internal control and testing and sampling. Since these aspects of an audit were believed to be widely accepted, it was no longer considered necessary to explicitly refer to them in the report. The change in practice intended by the original wording had occurred.

During the ten years from 1939 to 1949, the profession's attention also focused on modifications of the "standard" report. Although SAP 1 made clear that the CPA should withhold an opinion in certain circumstances, a disclaimer of opinion was not explicitly required. Many CPAs issued reports that recited their procedures in considerable detail but did not say whether the audit described was sufficient to express an opinion. The mere absence of remarks concerning the statements presumably indicated that the auditor took no responsibility for them.

In recognition of the need to clarify reporting responsibilities, SAP 23 was adopted by the Institute in 1947. The statement modified SAP No. 1 as follows:

> The independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements taken as a whole. In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements taken as a whole and should indicate clearly his reasons therefor.[14]

SAP 23 also specified the choices of report types available to the auditor: (1) an unqualified opinion, (2) a qualified opinion, of (3) a disclaimer of opinion. The statement indicated that the significance of the exceptions should be the criteria used to select the appropriate report type.

Although the primary focus of SAP 23 was the requirement that a disclaimer be expressly stated when no opinion could be rendered, the pronouncement also contained the first authoritative recognition of unaudited financial statements. The recognition was in the form of a dispensation to the CPA regarding the requirement that a written disclaimer accompany financial statements on which no opinion could be expressed. In setting forth the disclaimer requirement, the Committee on Auditing Procedure stated:

> However, when financial statements prepared without audit are presented on the accountant's stationery without comment by the accountant, a warning; such as "Prepared from the Books Without Audit," appearing prominently on each page of the financial statements is considered sufficient.[15]

This exemption was not contained in the exposure draft of SAP 23, but was added to the final statement based on practitioners' comments on the exposure draft. This exception pertained to unaudited financial statements only when they were presented on the accountant's stationery without his comments. Thus, the use of plain paper was tacitly permitted and a written disclaimer was required only if the CPA commented on the financial statements prepared without audit.

The evolution of a standard report had set the stage for the development of other report forms that could be considered as having special significance. In 1954, in the Institute pronouncement *Generally Accepted Auditing Standards,* the position set forth in SAP 23 was officially recognized as the fourth standard of reporting.

Landmark VII—The Adverse Opinion

In 1961, formal recognition was given to a distinct new modification of the standard report. SAP 31, "Consistency," created a new report category under the caption "change to a principle or practice which lacks general acceptance":

> Where the effect of a change to a principle or practice which is not generally accepted is material, the independent auditor should so state in his report. Such statement requires either a qualification of the independent auditor's opinion as to fair presentation in conformity with generally accepted accounting principles or, if the change is sufficiently material, an adverse opinion on the financial statements taken as a whole.[16]

A year later, 1962, SAP 32 was issued which contained the following definition of an adverse opinion and the criteria for when one should be issued:

> An adverse opinion is required in any report where the exceptions as to fairness of presentation are so material that in the independent auditor's judgment a qualified opinion is not justified. In such circumstances a disclaimer of opinion is not considered appropriate since the independent auditor has sufficient information to form an opinion that the financial statements are not fairly presented.[17]

This modification of reporting standards was aimed at prohibiting the auditor from disclaiming an opinion to avoid the more definitive and perhaps, from the client's viewpoint, more distasteful adverse opinion.

SAP 32 was not restricted to adverse opinions. It was a comprehensive statement that sharpened the auditor's reporting responsibilities under the fourth standard of reporting. In addition to defining the four types of audit reports the statement discussed unaudited statements, piecemeal opinions, negative assurance, reliance on other auditors and the distinction between the "except for" and the "subject to" forms of qualification.

The distinction between "except for" and "subject to" qualifications had particular significance. Prior to SAP 32, both types of reports were used interchangeably for *all* types of exceptions. The difficulty this practice posed for assessing the significance of qualifying phrases in the opinion paragraph was undoubtedly a critical consideration in the SEC's conclusions in ASR 90:

> A "subject to" or "except for" opinion paragraph in which these phrases refer to the scope of the audit, indicating that the accountant has not been able to satisfy himself on some significant element in the financial statements is not acceptable in certificates filed with theCommission in connection with the public offering of securities. The "subject to" qualification is appropriate when the reference is to a middle paragraph or to footnotes explaining the status of matters which cannot be resolved at statement date.

When the Committee on Auditing Procedure issued SAP No. 32, they adopted a similar position. However, the committee was not merely endorsing the SEC's view. Some time prior to the issuance of ASR No. 90, the committee had submitted a draft of SAP 32 to the SEC that contained this reporting guideline. Thus, the profession took the initiative in creating this reporting distinction.

SAP 32 also was the first official pronouncement to contain a section specifically devoted to unaudited statements. Although discussion of unaudited statements was brief, several new guidelines and requirements were advanced.

SAP 32 contained the first authoritative definition of unaudited financial statements. In addition, the pronouncement required that such financial statements with which the auditor is in any way associated be marked on each page as unaudited whether accompanied by the auditor's comments or not. The committee also expressed its preference that a disclaimer accompany all unaudited statements and required a disclaimer when such statements were accompanied by the CPA's comments.

These reporting requirements were virtually the same as those set forth in SAP 23. The term "in any way associated," however, appeared for the first time in SAP 32. Since association was not defined, many CPAs continued to follow plain paper reporting practices under the view that, since the accountant's name did not appear in connection with the statements, there was no association with them.

Two years after the release of SAP 32, the subject of unaudited statements was again on the agenda of the Committee on Auditing Procedure. Concern arose because SAP 32 left unresolved certain questions concerning the

term "association," the definition of unaudited statements, the propriety of plain paper, and the CPA's association with false or misleading statements. These concerns ultimately led to the publication of SAP 38 in 1967, the first statement devoted entirely to unaudited financial statements.

SAP 32 was the culmination of a trend in the increasing explicitness of reporting guidelines for audit reports that began with SAP 1. Specifying that an opinion should be withheld in certain circumstances was not enough (SAP 1). The need to disclaim also had to be specified (SAP 23). Requiring the auditor to disclose the reasons for a disclaimer was insufficient. An adverse category of reports had to be established to avoid concealment of important information (SAP 32). A distinction in the types of qualifications was articulated to clarify the category of exception being reported (SAP 32). This trend has continued to develop in the reporting guidelines for limited assurance engagements.[18]

Landmark VIII—The Seven-Year Scratch

Although the 1949 version of the standard report underwent minor modifications, such as substituting the term "retained earnings" for the word "surplus" and adding the statement of changes in financial position as a basic financial statement, no major efforts to revise the report occurred until 1965. In that year an itch developed to revise the report that was scratched for seven years.

The impetus for revision came from increased criticism of the accounting profession due to widely publicized audit failures and growing litigation against audit firms. Many accountants believed the criticism and litigation were based on misunderstanding of the auditor's function and the meaning of the auditor's report. In 1964, the AICPA's public relations counsel stated:

> Too many stockholders haven't the foggiest idea what your certificate means, and, if I may say so, I think the time is ripe for its revision in layman's language and in the light of changed circumstances in the past 30 years—particularly that of wide stock ownership.*

The Committee on Auditing Procedure focused on four major areas for potential revision:

- The inherent limitations of financial statements and the nature of generally accepted accounting principles.
- The description of audit scope.
- The distinction between the responsibilities of management and the auditor.
- The meaning of "present fairly . . . in conformity with GAAP."

Financial Statement Limitations and the Nature of GAAP. The committee was concerned that the auditor's report did not adequately describe the judgments required by GAAP and the resulting limitations on financial statements. Through a series of successive proposed SAPs, the committee attempted to create standard report wording to capture these concepts.

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* Note that over thirty years after "certificate" was taken out of the report, the AICPA public relations staff still used the term.

Ultimately, the committee abandoned the effort to describe GAAP and the limitations of financial statements in the auditor's report. This decision was rationalized on the basis of *APB Statement No. 4* and *APB Opinion No. 22.* Statement No. 4 presented the basic concepts and accounting principles underlying financial statements. Opinion No. 22 required disclosure of significant accounting policies. The committee believed that these pronouncements might be relied on to communicate the nature of GAAP and financial statement limitations. However, this judgment was undoubtedly colored by the difficulty experienced by the committee in trying to agree on a concise description of these matters in the auditor's report.

Description of Audit Scope. The committee was concerned with whether the nature and limitations of an audit were adequately described in the auditor's report. It proposed revisions in the scope paragraph in three major areas:

1. The phrase "We have examined" was believed to lack precision. The committee recommended the phrase "We have audited."
2. The term "generally accepted auditing standards" did not, in the committee's judgment, specify the particular standards being referred to or their source. The committee suggested that the phrase "of the American Institute of Certified Public Accountants" be added immediately following the term "generally accepted auditing standards."
3. The committee believed that the phrase ". . . and accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances" was too ambiguous. It felt the concepts of testing, evidence and auditor judgment needed greater emphasis in the report. The committee proposed the alternative phrase "Accordingly, we applied auditing procedures to the financial statements and to the underlying data and transactions selected by us from the company's records; we consider the auditing procedures to be of the nature and to the extent sufficient to provide a basis for our opinion expressed below."

Distinction Between Management and Auditor Responsibilities. In the committee's judgment, the scope paragraph did not adequately convey the distinction between management's responsibility for the financial statements and the auditor's responsibility for the conduct of the audit and expression of an opinion. To overcome this defect, the committee recommended that the phrase "these statements are based on the Company's records and other representations of the Company's management" be inserted in the scope paragraph.

"Present Fairly . . . In Conformity with GAAP." The repositioning of the terms "present fairly" and "in conformity with GAAP," created an unfortunate legacy for the accounting profession. The committee believed that the term "present fairly" was open to too many interpretations as reflected in legal decisions and critical articles. The committee recommended the phrase be deleted and replaced with "present in all material respects."

The culmination of the seven-year deliberation over the standard report resulted in the following recommended report:

> We have audited the accompanying balance sheet of XYZ Company as of December 31, 1972, and the related statements of income,

shareholders' equity, and changes in financial position for the years then ended. These statements are based on the Company's records and other representations of the Company's management. Our audit was made in accordance with the generally accepted auditing standards of the American Institute of Certified Public Accountants. Accordingly, we applied auditing procedures to the financial statements and to the underlying data and transactions selected by us from the Company's records; we consider the auditing procedures to be of the nature and to the extent sufficient to provide a basis for our opinion expressed below.

In our opinion, the financial statements mentioned above present in all material respects the financial position of XYZ Company at December 31, 1972, and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles applied on a consistent basis.[19]

Although a substantial consensus existed within the committee that a revised report would better communicate the auditor's responsibilities, the efforts to arrive at a solution failed. Many committee members, based on the advice of the AICPA's public relations division, believed that:

- Proposed revisions, while technically correct, had unacceptable public relations implications for the public and regulatory agencies.
- Legal interpretations of the auditor's function, role and responsibilities would probably not be altered by a more precise description of those attributes in the auditor's report.
- The increasing effect of "consumerism" presented an unacceptable environment in which to attempt to describe limitations of the auditor's responsibilities in a revised report.

The belief that the report needed revision to improve its communicative abilities was overshadowed by concern that various segments of the public might view the revision as an attempt by the profession to dilute its responsibilities. The increased visibility of the auditor's report raised a new obstacle to its revision. Proposed changes in the report, unlike those of previous revisions, were beginning to fall under the scrutiny of financial statement preparers and users. The profession now had to consider how these parties might perceive not only the new wording but also the motives underlying the proposed changes.

Landmark IX—SAS 5

In 1975, the auditing standard setting body took a somewhat different approach to clarifying the auditor's standard report. Instead of changing the wording in the report, an SAS was issued to deal with the persistent problem of what was meant by "present fairly . . . in conformity with GAAP." Since previous attempts to find substitute wording for this phrase were unsuccessful, the issuance of an SAS in effect interpreted the meaning of the phrase while leaving it intact in the report.

SAS 5 was intended to accomplish several objectives. First, it gave guidance to the auditor in fulfilling the responsibility for forming an opinion as to whether financial statements present fairly in conformity with GAAP. Second,

a formal statement on auditing standards elaborating on this concept made explicit what the accounting profession believed the auditor's responsibility was. Finally, publication of a standard dealing with the concept provided a limited means of informing other third parties, such as report users, what the auditor intended in this part of the report.

Although SAS 5 defined generally accepted accounting principles, the substantive guidance concerned how the auditor was to judge the "fairness" of the overall financial statements. The SAS specified that fairness should be judged within the framework of GAAP and that this judgment involved determining that:

- The accounting principles used have general acceptance.
- The accounting principles applied are appropriate in the circumstances.
- The financial statements contain the appropriate disclosure.
- The financial statements present the substance of the events and transactions within an acceptable range of approximation.

Although SAS 5 likely accomplished the objectives of providing guidance to auditors about the meaning of "present fairly in conformity with GAAP" and establishing the profession's interpretation of the phrase, it is doubtful if the SAS contributed much toward educating report readers. The technical orientation of an SAS and its limited distribution make it an ineffective tool for communicating with report users.

Landmark X—Reports on Comparative Statements

SAS 15, issued in 1977, redefined the meaning of the reference in the fourth standard of reporting to financial statements "taken as a whole." The SAS concluded that the phrase should be considered to apply not only to the current period financial statements but also to the statements of one or more prior periods presented on a comparative basis with those of the current period.

This clarification introduced the concepts of "continuing auditor" and "updating a report." The significance of this SAS was to require an auditor who had examined the financial statements of the current period and one or more consecutive periods immediately prior to the current period to re-express a previous opinion or, if circumstances warranted, to express a different opinion from that previously expressed on the prior year statements. In effect, the auditor was explicitly required to consider information obtained during the examination of the current-period statements as that information might relate to prior-period comparative statements.

The resulting standard report was:

> We have examined the balance sheets of ABC Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and changes in financial position for the years then ended. Our examinations were 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 financial statements referred to above present fairly the financial position of ABC Company as of December 31, 19X2 and 19X1, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.[20]

The report change reflected the auditor's new reporting responsibilities for comparative statements. However, the major revision in report wording was to put appropriate phrases in the plural form. The basic wording of the report remained unchanged.

Landmark XI—Another Seven-Year Itch

Seven years after the 1972 proposed revision, the Auditing Standards Board (ASB) again began considering a revised standard report. The impetus for this consideration stemmed from the recommendations of the Cohen Commission. The commission, relying partly on research and partly on congressional and regulatory studies, stated:

> Evidence abounds that communication between the auditor and users of his work—especially the auditor's standard report—is unsatisfactory . . . Recent research suggests that many users misunderstand the auditor's role and responsibility, and the present standard report only adds to the confusion.

Thus, it was largely the same reasons that caused the 1972 revision to be considered that gave rise to the ASB's new deliberations.

After extensive research, public hearings and deliberation, the ASB issued an exposure draft of a revised report. The recommended report was:

> Independent Auditor's Report
>
> The accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and changes in financial position for the year then ended are management's representations. An audit is intended to provide reasonable, but not absolute, assurance as to whether financial statements taken as a whole are free of material misstatements. We have audited the financial statements referred to above in accordance with generally accepted auditing standards. Application of those standards requires judgment in determining the nature, timing and extent of tests and other procedures and in evaluating the results of those procedures.
>
> In our opinion, the financial statements referred to above present the financial position of X Company as of December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended in conformity with generally accepted accounting principles.[21]

The major changes from the existing form of report were:

- Add a title containing the word independent.
- Add an assertion that the financial stateents are the representations of management.
- Add a statement that "an audit is intended to provide reasonable but not absolute, assurance as to whether the financial statements taken as a whole are free of material misstatements."

- Replace the word "examined" with the word "audited."
- Include in the scope paragraph a statement that "Application of [generally accepted auditing standards] requires judgment in determining the nature, timing and extent of tests and other procedures and in evaluating the results of those procedures."
- Delete the word "fairly" from the opinion paragraph.
- Delete the reference to the consistency of application of accounting principles.

Since several of these proposed revisions were the same ones considered in 1972, there seems to be agreement that these aspects of the report should be changed. The disagreement concerns how the changes should be made. The ASB was no more successful than the Committee on Auditing Procedure in reaching a consensus on the form of revision.

The board received an unprecedented number of comment letters on the exposure draft. Although each of the proposed changes had merit for some people, the total effect of the changes was apparently not seen as an improvement. While the exposure draft stressed that the proposed report would not change the auditor's responsibilities in conducting an audit nor alter the basis for forming an opinion, many commentators and, ultimately, board members decided that the proposed report would be seen as an effort to reduce the auditor's responsibility. The overall reaction to the report was that it was too negative.

Although many of the suggested changes faced opposition, the controversy boiled down to deletion of the word "fairly" in the opinion paragraph. One of the most frequent comments given in support of retaining "fairly" was that it provided a good way to convey the notions of GAAP's inexactitude and the auditor's judgment. Others opposed deletion because they believed it would make the auditor's report seem less like an endorsement of the financial statements. Still others believed that "fairly" was meaningful both to the public and to the courts and that its deletion would result in confusion rather than clarification.

Those who favored deleting "fairly" believed it was the primary source of confusion in the report. They felt the term implied that the auditor was taking more responsibility than intended. That is, that the term suggested the auditor was, in effect, forming two opinions: one as to fairness and another as to conformity with GAAP. Others who favored deletion felt the term was either redundant or so nebulous as to be meaningless.

The pivotal factor in the proposed revision was whether the lack of precision in the term "fairly" was a fatal fault or an irreplaceable virtue. Ultimately, a majority of the board preferred to retain "fairly." In view of that preference, the board decided that it would not be worthwhile to consider revising the scope paragraph if the opinion paragraph would retain "fairly." The board believed that it was unlikely that further deliberations would result in significant enough improvement of the report to warrant the cost of change.

Landmark ??

The auditor's standard report has remained essentially unchanged for the last 33 years. The status quo has persisted in spite of what appears to be

widespread agreement that the standard report is not understood by users and could be improved to better communicate the role and responsibilities of the auditor. Why?

One reason is the vehement disagreement over how the report should be worded to achieve better understanding and communication. This is apparent from the last two major efforts to revise the report.

Another perhaps less apparent reason might be that there is disagreement over whether the major objective of the report is to communicate to users the role and responsibilities of the auditor. Auditors may be more concerned with the protective qualities of the report than with its communicative qualities. The language in the current report has been interpreted in court decisions and has a known effect. Readers, although they may not fully understand the significance of the report, are at least accustomed to the wording. There may be little direct value to auditors from better comunication, but a great deal of exposure to unknown consequences if the report is changed.

There are no major calls for report revision from parties outside the profession. The dormant nature of the report over the past three decades has caused readers to view it as a symbol. Proposals to alter that symbol receive a careful scrutiny from parties outside the profession who are concerned that auditors may be redefining their responsibilities and shifting some of them to others. The report is much more visible than it was in the early days of the profession. Changes in the report no longer lie solely within the profession's domain.

The next landmark in audit reporting probably will not focus on revising the auditor's report on financial statements. Instead, it is likely that the report will be expanded to cover financial information not currently included. Areas such as supplementary information and current value financial presentations represent possibilities. The only safe bet is that the evolution will continue.

Footnotes

1. "Uniform Accounting," *Federal Reserve Bulletin*. Federal Reserve Board, 1917.
2. *Ibid.*, p. 3.
3. *Ibid.*, p. 24.
4. "Verification of Financial Statements," *Federal Reserve Bulletin*. Federal Reserve Board, 1929.
5. *Ibid.*, p. 24.
6. *Ultramares Corporation v. Touche* (255 N.Y. 170, 174, N.E. 441, 1931).
7. "Editorial," *Journal of Accountancy*, July, 1931.
8. *Audits of Corporate Accounts*, "Correspondence Between the Special Committee on Cooperation With Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange," AICPA, 1934, pp. 30-31.
9. Speech by James M. Landis, commissioner, Securities and Exchange Commission before the New York State Society of Certified Public Accountants, January, 1935.
10. *Statements on Auditing Procedure No. 1*, "Extensions of Auditing Procedure," Committee on Auditing Procedure, AIA, September, 1939, p. 4.
11. *Ibid.*, p. 5.
12. *Ibid.*, p. 5.
13. *Statements on Auditing Procedure No. 24*, "Revision in Short-Form Accountant's Report or Certificate," Committee on Auditing Procedure, AIA, October, 1948.
14. *Statements on Auditing Procedure No. 23*, "Clarification of Accountant's report When Opinion Is Omitted," Committee on Auditing Procedure, AIA, December 1947).
15. *Ibid.*

16. *Statements on Auditing Procedure No. 31,* "Consistency," Committee on Auditing Procedure, AIA, October, 1961.

17. *Statements on Auditing Procedures No. 32,* "Qualifications and Disclaimers," Committee on Auditing Procedure, AIA, September, 1962.

18. Existing professional standards recognize 19 different limited assurance engagements and provide specific reporting guidance for each engagement. See "An Analysis of Professional Standards for Limited Assurance Engagements," Alan J. Winters (an unpublished paper) and *Limited Audit Engagements and the Expression of Negative Assurance,* J. Alex Milburn (CICA), 1980. With the formation of the Accounting and Review Services Committee in 1977, the responsibility for setting standards for unaudited financial statements of nonpublic companies was separated from the responsibility for setting auditing standards.

19. "Proposed Statement on Auditing Procedure, The Independent Auditor's Short-Form Report," March 2, 1979 draft, p. 3. (Note that in 1974 with the issuance of SAS2 the phrase "short form" was replaced by "standard.")

20. *Statement on Auditing Standards No. 15,* "Reports on Comparative Financial Statements," AICPA, December, 1976, p. 3.

21. "Proposed Statement on Auditing Standards, The Auditor's Standard Report," September 10, 1980 draft, p. 11.