

INVESTORS', AUDITORS', AND LENDERS' UNDERSTANDING OF THE MESSAGE
CONVEYED BY THE STANDARD AUDIT REPORT

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Executive Summary

The objective of the unqualified standard audit report (SAR) is to add credibility to management's financial statements and facilitate decision making; however, its effectiveness depends on the extent to which various stakeholders have a shared meaning of the concepts being communicated. Unless there is a shared meaning, misunderstandings will result, which can lead to unintended investments, misallocation of resources, unnecessary litigation, and/or loss of confidence in the audit function. It is therefore important to identify, understand, and wherever possible, reduce material communication gaps among the issuers and users of the SAR.

The purpose of this study is two-fold. First, we evaluate the extent to which there is congruence (or alternatively a communication gap) among three stakeholder groups in their understanding of the objectives and limitations of the SAR. We refer to this as "macro" analysis because of its broad focus. Second, we evaluate the extent to which there is congruence in the stakeholders' interpretation of technical language used in the SAR. We call this a "micro" analysis because of its focus on specific concepts and terms. The stakeholders chosen for the study are auditors (representing issuers of the SAR) and investors and lenders (representing two important user communities).

With respect to the macro analysis, we focused on seven areas that have been of interest to standard setting, research, or practice: (i) importance of SAR in making investment and lending decisions (decision-usefulness); (ii) importance of SAR in assessing that the financial statements are free from material fraud (information risk); (iii) level of confidence the SAR provides on the company's future viability (viability risk); (iv) level of confidence the SAR provides on how well the company is managed (governance risk); (v) the level of confidence the SAR provides that the company is a sound investment (investment soundness risk); (vi) level of confidence the SAR provides that the company will meet its strategic goals (strategic risk); and (viii) the likelihood the auditors have detected material fraud in the financial statements (fraud detection risk). Over the years, there has been considerable debate about the role and importance of the SAR in assessing each of these areas.

With respect to the micro analysis, we focus on the SAR's use of the terms "material misstatements," "reasonable assurance," "test basis," "significant estimates" from the scope paragraph and "present fairly," from the opinion paragraph. We chose these terms because they represent technical concepts that are susceptible to misinterpretation. Although the Commission on Auditors' Responsibilities (CAR 1978) called for the elimination of such technical language, these terms continue to be in use. Standard setters have apparently chosen to clarify rather than eliminate these terms (e.g., SAS 69 clarifies the term "present fairly").

We gathered data from a controlled automated internet-based experiment involving 154 participants (78 auditors, 43 investors, and 33 lenders). In the experiment, each participant reviewed background information on a hypothetical private company in the retail hardware industry. The information included the nature of the business, the number of years the company had been audited, and summary financial and non-financial information (e.g., sales, income, total assets, ratios, number of stores). Therefore, all participants had the same case background information. The current unqualified SAR was then provided. The participant then answered a series of questions that focused on their interpretation of the macro and micro factors.

For analysis purposes, we proceed along two paths. First, we describe overall results, which represent a pooling of participants' responses. Second, we consider between group differences, which we classify as being consistent with one of three patterns: (i) the user groups (investors and lenders) differ from the auditor group (which we define as a "type I communication gap"); (ii) one user group and the auditor group differ from the other user group ("type II" gap); and (iii) the user groups differ from each other as well as from the auditor group ("type III gap"). Arguably, a type I gap is of the greatest concern to standard setters, since it represents a fundamental communication gap between the issuers and users of the SAR and is likely to lead to misinterpretation and potentially litigation. A type II gap potentially represents an opportunistic communication gap, driven by a particular user's context and a type III gap represents a complete absence of shared meaning.

Overall participants rate the SAR as important in investing and lending decisions as well as for assessing whether financial statements are free from material fraud. Further, the SAR provides a high level of confidence that the company will remain viable. On the other hand, the SAR provides a relatively lower level of confidence that the company is well managed, is a sound investment, or that the company will meet its strategic goals. Thus, consistent with auditing standards the assessed overall decision usefulness of SAR appears to be driven by its use in assessing information and viability risks but not governance, investment soundness or strategic risks. Nevertheless, participants assessed only a 50-50 chance that auditors have detected material fraud even when the SAR is present, suggesting that while participants consider the SAR to be important in assessing whether the financial statements are free from material fraud, they are somewhat skeptical of auditors' ability to detect material fraud.

With respect to between group differences in the understanding of the macro factors, we found a type I gap (i.e., the user groups differ from the auditors) in five of the seven areas. Specifically, users consider the SAR to be relatively more important in assessing that the financial statements are free from material fraud than auditors. The same pattern of results holds for the level of confidence that SAR evokes about company management, investment soundness of a company, whether the company is likely to meet its strategic goals, and the likelihood that auditors have detected material fraud in the financial statements. With respect to the level of confidence that SAR provides about how well a company is managed, investment soundness of a company and a company ability to meet its strategic goals, the mean confidence for the auditors is relatively lower than that of the users. Finally, while auditors assess the likelihood that material frauds have been detected at about 60%, users assess a relatively lower likelihood of detection at 44%.

We found a type II gap for SAR's decision usefulness and its role in assessing viability. On these two macro factors, auditors and bankers had the same shared meaning and differed from investors. Investors find SAR to be of higher importance for making investing decisions than auditors and bankers but the investors also have relatively lower confidence that the presence of SAR will assure viability.

On the interpretation of the technical terms in the SAR, participants overall considered as "material" fraud an amount that was 2% of reported sales (3.5% of reported total assets). However, they expected the audit plan to detect fraud amounting to 3.5% of reported sales and 6.4% of reported total assets, suggesting concern about whether the audit plan is adequate for fraud detection. The phrase "fairly present" provides very high assurance (77.41%) that financial statements capture economic substance and an even higher assurance (86.39%) that the financial statements conform to GAAP. "Reasonable assurance" is interpreted by participants as providing high comfort (78.96%) that the financials are free from material misstatements. The findings also indicate that participants assess that the SAR provides varying assurance levels across different accounts. With respect to examining evidence "on a test basis" to substantiate financial statement amounts and disclosures, participants take that to mean auditors typically examine a

mean of about 30% of sales transactions, which is slightly higher than the mean of 26% of sales transactions that they think auditors should test. Participants report that management exercises a high level of judgment in preparing the financial statements. Finally, participants assess that auditors use a mean of 8.49% of net income to determine materiality compared to the mean of 7.47% that they think auditor should use.

Finally, the within group differences in the interpretation of the technical terms underscore the confusion described by CAR. There was one type I gap (auditors indicated they should use a relatively lower percent of net income for materiality than the users), 6 type II gaps with no clear patterns, and 1 type III gaps

Taken together, these results show that the current SAR results in important type I communication gaps, which is evidence that in spite of the enhanced scope paragraph in SAS 58, there remains some confusion or there is absence of shared meaning on the objectives and limitations of the SAR. A potential vehicle for narrowing these type I communication gaps is to add a statement in the SAR that the audit does not address governance risk, strategic risk or investment soundness risk. The prevalence of type II gaps in the micro-analysis suggests a potential for opportunistic interpretation of the technical terms, which suggests less urgency in revising or eliminating those terms.

INTRODUCTION

The standard unqualified financial statement audit report (SAR) represents the auditor's communications of findings to various users of the financial statements (AICPA SAS No. 58 1988). However, communication is a "two way street" and its effectiveness depends on the extent to which the communicator and the audience have a shared meaning of the concepts being communicated (Duncan and Moriarty 1998). Unless there is a shared meaning, misunderstandings will result. In a capital market, such misunderstanding can lead to unintended investments, misallocation of resources, unnecessary litigation, and/or loss of confidence in the audit function. Accordingly, it is important to identify, understand, and whenever possible, reduce material communication gaps between auditors and users of the audit report.

The purpose of this study is two-fold. First, we evaluate the extent to which there is congruence (or alternatively a communication gap) among three stakeholder groups in their understanding of the objectives and limitations of the SAR. We refer to this as a "macro" analysis because of its broad focus on the roles and responsibilities of the auditor. Second, we evaluate the extent to which there is congruence in the stakeholders' interpretation of technical language used in the SAR. We refer to this as a "micro" analysis because of its focus on specific terms and concepts. The stakeholders chosen for the study are auditors (representing the issuers of the SAR) and investors and lenders (representing two important user communities).

Addressing these issues is important because the SAR is the primary vehicle by which auditors communicate their findings to users and any unintended communication gap diminishes the value of the SAR. The format and content of the SAR has been and remains a matter of considerable practice and research importance (Jaenicke and Wright 1993; McEnroe and Martens 2001). In 1974, the AICPA appointed the Cohen commission to investigate whether an

expectation gap existed in the United States (Commission on Auditors Responsibilities [CAR] 1978). The CAR concluded that such a gap did exist and it identified several possible deficiencies in the then “short form” audit report.¹ In particular, CAR concluded that the report created confusion about the relative responsibilities of management and auditors, it did not clarify the basic objective and limitations of the audit (e.g., users equated the SAR with financial soundness), and it used technical language that was easily misinterpreted (e.g., present fairly). The CAR called for an improved audit report and the deletion of confusing technical language.

The ASB responded by issuing SAS 58 (1988) that called for an introductory paragraph that clearly sets out relative responsibilities of management vis-à-vis the auditor and a scope paragraph that sets out the nature and limitations of the audit. However, the “present fairly ... in conformity with GAAP” language was maintained and subsequently clarified by SAS 69 (AICPA 1992).

Although some prior studies have evaluated the communication efficacy of SAS 58 (e.g., Kelly and Mohrweis 1989; Miller et al. 1993), the passage of the Sarbanes Oxley Act (2002) has significantly altered the reporting environment, necessitating a reconsideration of the SAR to identify and remediate significant communication gaps. Further, the trend towards harmonizing worldwide auditing standards has triggered the need to evaluate the effectiveness of the SAR as a potential multi-jurisdiction communication vehicle. It is because of these reasons that the AICPA and IAASB joined forces to launch a research initiative to provide a better understanding of users' perceptions of the financial statement audit and the auditor's report.² This research is

¹ The short form report had 2 paragraphs, the first of which described the financial statements and period audited, and the second provided the opinion. The “long form” standard audit report covers three primary issues; an introductory paragraph that describes the financial statements audited and the relative responsibilities of management and the auditors; a scope paragraph that describes the scope and nature of an audit (e.g., evidence is collected on a test basis, only reasonable assurance is provided, and audits involve the evaluation of estimates); and the opinion, which combines fairness of presentation and conformity with GAAP together in a single phrase.

² See <http://www.ifac.org/MediaCenter/?q=node/view/211>

intended to examine issuers' and users' interpretations of the SAR in the USA. Our findings provides important information that can be used as a basis for future revisions to the auditor's report.

At the macro-level users expectations may differ from those of auditors and standard setters (see Best et al. 2001). Different expectations about the roles and responsibilities of the audit function could carryover into the interpretation of the SAR. Consequently, users could interpret SAR as sending a signal about, for instance, the investment attractiveness of a company, the auditor's role in detecting fraud, and a guarantee that the financials are free from misstatements. At the micro-level, a communication gap could exist if users interpret technical terms or concepts in the SAR differently from their intended meanings (see e.g., McEnroe and Martens 1988). Such terms include "present fairly," "in all material respects," "reasonable assurance," "material misstatement," "test basis," and "assessment of accounting principles and estimates."

It is important to maintain the distinction between the two sources of potential communication gaps because they arise for different reasons and must be addressed through different vehicles. Even if there was perfect congruence between users and auditors regarding the audit function and limitations, differences in interpretation could nonetheless result from the presence of terms or concepts that are imprecise or ambiguous. Likewise, even if precise terms were used in the SAR or imprecise terms are clarified by stand-alone standards (e.g., SAS 69), a communication gap could exist as a result of differences in expectations of what the audit function is or should be. To date, changes in the SAR (e.g., from the short form report to the current SAS 58 "long form" report) have focused primarily on clarifying the role and responsibilities of auditing but not on the interpretation of the technical terms used in the SAR.

A rigorous identification of the source of communication gaps is the starting point in deciding which issues to focus on in evaluating ways to eliminate or mitigate expectation gaps. Potential ways to mitigate macro level differences may be to change the wording of the audit report to clarify the roles and limitations of the audit and/or for the auditing profession to mount education programs and communication releases for users. Some expectation gap issues may, however, relate to fundamental differences of views regarding the roles and responsibilities of the auditor, which require analyses as to cost-benefit considerations in evaluating whether and how the auditing profession may need to alter professional standards and practices. Even though perception differences can exist, very little research has been done at the micro-level. Consequently little is known about how users actually interpret technical terms used in the auditor's report.

To investigate these issues, in an experiment 154 participants (43 average investors, 78 auditors, and 33 lenders) are provided the standard audit report of a disguised company and asked to respond to 7 questions dealing with the objectives and limitations of the SAR (macro factors) and their understanding of five technical terms used in SAR to convey the audit findings (micro factors). Our primary analysis focuses on between group differences, which we classify as being consistent with one of three patterns: (i) the user groups (investors and lenders) differ from the auditor group (which we define as a "type I gap"); (ii) one user group and the auditor group differ from the other user group ("type II" gap); or (iii) the user groups differ from each other as well as from the auditor group ("type III gap"). Arguably, a type I gap is of the greatest concern to standard setters, since it represents a fundamental communication gap between the issuers and users of the SAR and is likely to lead to misinterpretation and potentially litigation. On the other hand, a type II gap potentially represents an opportunistic communication gap,

driven by a particular user's context and a type III gap represents a complete absence of shared meaning.

Overall (i.e., a pooled analysis) participants rate the SAR as important in investing and lending decisions as well as for assessing whether financial statements are free from material fraud. Further, the SAR provides a high level of confidence that the company will remain viable. On the other hand, the SAR provides a relatively lower level of confidence that the company is well managed, is a sound investment, or that the company will meet its strategic goals. Thus, the assessed overall decision usefulness of SAR appears to be driven by its use in assessing information and viability risks but not governance, investment soundness or strategic risks. Nevertheless, participants assessed only a 50-50 chance that auditors have detected material fraud even when the SAR was present, suggesting that while participants consider the SAR to be important in assessing whether the financial statements are free from material fraud, they are somewhat skeptical of auditors' ability to detect material fraud.

With respect to between group differences in the understanding of the macro factors, we found a type I gap (i.e., the user groups differ from the auditors) in five of the seven areas. Specifically, users consider the SAR to be relatively more important in assessing that the financial statements are free from material fraud. The same pattern of results hold for the level of confidence that SAR evokes about company management, investment soundness of the company, whether the company is likely to meet its strategic goals, and the likelihood that auditors have detected any material fraud in the financial statements. Finally, while auditors assess the likelihood that material frauds have been detected at about 60%, users assess a relatively lower likelihood of detection at 44%.

We found a type II gap for SAR's decision usefulness and its role in assessing viability. On these two macro factors, auditors and bankers had the same shared meaning but differed from investors. Investors find SAR to be of higher importance for making decisions than auditors and bankers but the investors also have relatively lower confidence that the presence of SAR will assure viability of the company.

On the interpretation of the technical terms in the SAR, participants overall (i.e., pooled analysis) considered as "material" fraud an amount that was 2% of reported sales (3.5% of reported total assets). However, they expected the audit plan to detect fraud amounting to 3.5% of reported sales and 6.4% of reported total assets, suggesting concern about whether the audit plan is adequate for fraud detection. The phrase "fairly present" provides very high assurance (77.41%) that financial statements capture economic substance and an even higher assurance (86.39%) that the financial statements conform to GAAP. "Reasonable assurance" is interpreted by participants as providing high comfort (78.96%) that the financials are free from material misstatements. The findings also indicate that participants assess that the SAR provides varying assurance levels across different accounts. With respect to examining evidence "on a test basis" to substantiate financial statement amounts and disclosures, participants interpret that to mean auditors typically examine a mean of about 30% of sales transactions, which is slightly higher than the mean of 26% of sales transactions that they think auditors should test. Participants report that management exercises a high level of judgment in preparing the financial statements. Finally, participants assess that auditors use a mean of 8.49% of net income to determine materiality compared to the mean of 7.47% that they think auditor should use.

Finally, focusing on the between group differences in the interpretation of technical terms (micro analysis), we found one type I gap (auditors had relatively lower percent of net

income than the users for materiality), six type II gaps with no clear patterns, and one type III gaps. The preponderance of the type II gaps suggests that the communication gap could be more opportunistic rather than fundamental. Nevertheless, more precise language may reduce the incidence and opportunities for such opportunistic interpretation.

Taken together these results indicate that the current SAR results in important type I macro communication gaps, which is evidence that in spite of the enhanced scope paragraph in SAS 58, the objectives and limitations of the SAR are not well understood or alternatively users and issuers have little shared meaning. A potential vehicle for narrowing these type I communication gaps is to add a statement in the SAR that the audit does not address governance risk, strategic risk or investment soundness risk. The prevalence of type II gaps in the micro-analysis suggests a potential for opportunistic interpretation of the technical terms, which suggests additional clarifications may be needed.

In the next section, we discuss reader-response theory as a theoretical framework for understanding how stakeholders interpret the SAR. This is followed by an analysis of the expectation gap literature, a discussion of our macro and micro factors, and the use of reader-response theory to posit research expectations. We then describe the method, followed by presentation of the results. The final section is devoted to a discussion of the major results and their implications for practice and future research. Appendix 1 provides a detailed literature review of prior studies on the expectation gap.

LITERATURE ANALYSIS

Reader Response Theory

In the mass communication and marketing literature, it has been shown that advertising text interacts with the knowledge, expectations, emotions, and motives of the reader which can

lead the same text to be subject to multiple interpretations (Scott 1994). In the judicial arena, judges routinely make different interpretations of the same regulation, statute, or constitutional provision (Scalia 1997). Typically, it is also possible to predict with remarkable success the interpretation that a particular judge will reach based on political predisposition. Therefore, stakeholders' motives, wishes and preferences can affect their interpretations of the SAR. Prior audit studies assume that the SAR contains claims accepted by the user. That is, the user is a passive reader of the message communicated by the SAR and research emphasis is on assessing the degree to which the user accurately understands the message.

This text centered approach has been found to be of limited use in the study of readers (Scott 1994). Correspondingly, emphasis in mass communication research has shifted to a "reader-response theory," which in essence postulates that readers are active interpreters of messages and can infer variable meanings in a text based on their own psychology, content, or motives (Scott 1994). A reader-response interpretation is based on the assumption that there is no one "correct" reading of a text (Elliot and Elliot 2005). Depending on context, an advertising audience can view a message with outright skepticism or resistance (Scott 1994). This theory suggests the need for more research on the SAR that considers the background that stakeholders bring to the interpretation task. Because auditors, bankers, and lenders have different backgrounds, they could, thus, view the SAR differently.

Two conditions facilitate the multiple interpretation of the SAR. First, because the SAR may contain imprecise language, there is room to misunderstand, ignore, or selectively interpret the intentions of standard setters who prescribed the language in the SAR (Scalia 1997). Second, because there have been known situations in which a SAR is issued when financial statements

are materially misstated (e.g., Enron), the reader can reasonably engage in opportunistic interpretation.

Based on reader-response theory, we posit that stakeholders do not read the SAR as passive readers but are active interpreters of the SAR and can infer variable meanings based on their own psychology, context, or motives (Scott 1994; Elliot and Elliot 2005). We consider the implications of such strategic interpretations to discuss potential between group differences in interpreting the micro and macro messages in the SAR. Between group differences can be consistent with one of three patterns: (i) the user groups (investors and lenders) differ from the auditor group (which we define as a “type I gap”); (ii) one user group and the auditor group differ from the other user group (“type II” gap); (iii) the user groups differ from each other as well as from the auditor group (“type III gap”).

Standard Audit Report and the Expectation Gap

The audit report adds credibility to management’s financial statements and facilitates stakeholders’ decisions. Standard setters and the auditing profession have an important and obvious interest in ensuring that there is little or no gap between what is intended to be communicated by the auditor and what is encoded by users, since a gap can erode confidence in the report, lead to poor decisions, and/or trigger unnecessary litigation. Nevertheless, there is evidence that a significant communication gap does exist and considerable effort has been devoted to curbing the gap (e.g., CAR 1978, CICA 1988, AICPA/IAASB 2007).

In 1974, the AICPA appointed the Cohen commission to investigate whether an expectation gap existed in the United States (Commission on Auditors Responsibilities [CAR] 1978). The CAR concluded that such a gap did exist and it identified several possible

deficiencies in the then “short form” audit report.³ Coextensively, the auditing professions in Australia (AUS 702), Canada, and UK (SAS 600) also moved to an expanded form of the audit report, which basically implements the innovations in the introduction and scope paragraphs of SAS 58.

Basic Objectives and Limitation of the Audit

The objective of the ordinary audit of financial statements is the expression of an opinion of the fairness of the financial position, result of operations, and its cash flows in conformity with GAAP (SAS 1). Over the years, considerable debate has ensued over the elasticity of this definition as it pertains to the (i) importance of SAR in making investment and lending decisions (decision-usefulness) ; (ii) importance of the SAR in assessing that the financial statements are free from material misstatement (information risk); (iii) level of confidence that the SAR provides on the company’s future viability (viability risk); (iv) level of confidence that the SAR provides on how well the company is managed (governance risk); (v) the level of confidence that the SAR provides that the company is a sound investment (investment soundness risk); (vi) level of confidence that the SAR provides that the company will meet its strategic goals (strategic risk); and (viii) the likelihood the auditors have detected material fraud in the financial statements (fraud detection risk) (see e.g., Libby 1979; Bailey et al. 1983; Kelly and Mohrweis 189; Jaenicke and Wright 1993; McEnroe and Martens 2001).

Decision Facilitation

³ The short form report had 2 paragraphs, the first of which described the financial statements and period audited, and the second provided the opinion. The “long form” standard audit report covers three primary issues; an introductory paragraph that describes the financial statements audited and the relative responsibilities of management and the auditors; a scope paragraph that describes the scope and nature of an audit (e.g., evidence is collected on a test basis, only reasonable assurance is provided, and audits involve the evaluation of estimates); and the opinion, which combines fairness and conformity with GAAP together in a single phrase.

There was early consensus on the decision facilitation role of the SAR. SAR was considered important to reduce the agency costs arising from management's private information (Mautz and Sharaf 1961; Wallace 1987; 2004). Thus, we expect participants to evaluate SAR as important in investment and lending decisions. Further, because average investors are likely to rely solely on publicly available audited financial statements while lenders are, where necessary, able to obtain additional information and collateral from borrowers, the decision facilitation role may be most important to investors, leading to a type II gap.

Assessing that the financial statements are free from material fraud

Fraudulent financial reporting is intentionally misstating the financial statements (AICPA 2002). Historically, auditing standards held that an ordinary audit was not planned to detect fraud. However, it appeared users assumed that audits are designed to detect fraud culminating in an expectation gap (Low 1984; Best et al. 2001; McEnroe and Martens (2001)). In the late 1980s, the ASB issued SAS 53 which expanded auditors' responsibilities to detect irregularities while acknowledging inherent limitations. SAS 53 was superseded by SAS 82 and SAS 99, which made the clearest statement of auditors' affirmative responsibility to plan the audit to detect material fraud. Given this trend, we expect participants to evaluate SAR as important in assessing that the financials are free from material fraud. Further, because auditors face litigation risk, we expect their assessments to be lower than users, leading to a type I gap.

Confidence in the company's future viability

As with fraud, auditor's responsibility to assess viability has evolved (see e.g., Carmichael and Pany 1993). Prior to the issuance of SAS 59, auditors did not have an affirmative responsibility to assess the viability status of their clients, although research suggested that users expected them to do this and read the SAR as if it was affirming of viability (Guy and Sullivan

1988; Kinney and Nelson 1996). SAS 59 was one of the expectation gap standards issued to bridge the gap between users and auditors. This trend suggests that the presence of the SAR will give a high level of confidence in viability, although because of strategic interpretation, auditors will have lower confidence than the users, leading to a type I gap.

Confidence that company is well managed; is a sound investment; or will meet its strategic goals

Auditing standards indicate that the SAR is not intended to provide evidence about how well a company is managed; whether it is a sound investment; or whether it will meet its strategic goals (AICPA 1988). Both a poorly managed and well managed company can get a SAR as long as their financial statements are fairly stated. The same is true of investment quality and the ability to meet strategic goals. There is no language in the SAR that can be objectively interpreted as opining on any of these macro issues. Thus, we expect relatively lower confidence across participants on these assurances. Nevertheless, reader response theory suggests that users are strategic readers of texts and will interpret text based on their own circumstances (Scott 1994). Users are more likely to read good management, sound investment, and accomplishment of strategic goals into the SAR. Thus, we expect users to have relatively higher confidence on these three variables than auditors, leading to type I gaps.

Likelihood the auditors have detected material fraud in the financial statements

This macro issue pertains to the auditors' knowledge, skills, and ability to detect material fraud in the financial statements. With the recency and publicity given to large frauds (including Enron, WorldCom, Xerox, Sunbeam, etc.), we expect participants to indicate a relatively low likelihood that auditors have detected fraud even in the presence of the SAR.

We pose the following research questions dealing with the macro issues discussed.

Question 1: What does SAR convey to auditors, investors and lenders about the nature and limitations of the audit report?

Question 2: Are there differences between users and auditors in their understanding of the nature and limitations of the audit function?

Technical language used in the SAR (Micro Factors)

As noted previously, the CAR noted that the SAR used technical language that was easily misinterpreted and called for the elimination of these terms (AICPA 1978). However, there has been no attempt by auditing standard setters to eliminate these terms. Rather, audit standards have sought to clarify one of them in SAS 69 (AICPA 1992). Paragraph 3 of SAS 69 indicates that the auditor's "judgment concerning the "fairness" of the overall presentation of financial statements should be applied within the framework of GAAP." This interpretation is not obvious from reading the audit report and may be in conflict with case law which treats the fairness issue as separate (relating to economic substance) from the GAAP conformance issue (see e.g., *United States v. Simon*, 425 F. 2d 796 (1969), certiorari denied 397 U.S. 1006 (1970). McEnroe and Martens (2001) examined partners and investors (sampled from the America Association of Individual Investors) perceptions about various aspects of the attest function. Participants responded to a series of questions on the attest function without the benefit of an audit report.⁴ One question asked the participants for their interpretation of "present fairly in conformity with GAAP." The majority of both auditors and investors chose the option which indicated that the word "fairly" adds something important to the phrase (i.e., this means the same as present in conformity with GAAP and also present in a non-misleading way). Thus, "fairly present" does not appear to have a universal meaning, in spite of SAS 69.

⁴ The expectation gap standards had been issued for over a decade and the participants presumably were familiar with those standards and the SAS 58 audit report. However, McEnroe and Martens (2001) asked participants to provide their responses "irrespective of any particular phraseology contained in the audit report." Thus, they were more interested in perceptions about the attest function, not what was communicated and encoded by the audit report.

Other technical terms in the SAR include “material misstatements,” “reasonable assurance,” “test basis” and “significant estimates” from the scope paragraph. With the exception of material misstatements, which has been studied as part of audit planning (Messier et al. 2005), few studies assess stakeholders interpretations of these technical terms. Reader-response theory will suggest that users will infer higher assurance, higher tests, lower materiality and lower estimates than auditors. But reader-response theory has been applied to whole texts not technical terms within the text. In light of the sparse research on technical terms, we pose the following research questions:

Question 3: How do auditors, investors and lenders interpret technical terms used in the standard audit report?

Question 4: Are there differences between users and auditors in the interpretations of the technical terms in SAR?

RESEARCH METHOD

Overview

The study entails a field experiment where auditors, lenders, and average investors are asked a series of questions concerning their interpretation of seven macro and five micro messages contained in the SAR of a hypothetical company. MBA students from a private university are employed as surrogates for average investors, as has been frequently done in prior studies (Elliott et al. 2007). Forty-three average investors, with a mean (σ) of 5.3 (5.8) years of work experience, were recruited from the Accounting core course in the MBA program.

Three hundred auditors currently in public practice were randomly selected from the AICPA membership list. These individuals first received a letter from the AICPA encouraging their voluntary participation in the project; the letter was followed with an email message with instructions on how to access the experimental case over the internet. Our email message was

returned as undeliverable for 75 participants, leaving 225 participants who had sufficient information to complete the study. Seventy-eight auditors responded, representing a 35% response rate (78/225), with a mean (σ) of 12.46 (11.11) years audit experience.

Contact individuals at various banks were identified by the AICPA to enlist lender participants. Thirty three bankers, with a mean (σ) of 13.8 (11.1) years audit experience, participated in the study by completion of the case over the internet. We do not know how many lenders were approached by the contact individuals so we cannot compute a response rate.⁵

The experiment began by providing background information on a hypothetical company based on actual firm in the retail hardware industry. This information described the nature of the business, noted the company had been audited for 27 years, and provided summary financial and non-financial information (e.g., sales, income, total assets, ratios, number of stores). The current unqualified SAR was then provided. The background information was followed by a series of questions that focus on participant interpretation of the SAR with respect to the macro and micro factors.

With respect to the macro analysis, we focused on the following areas: (i) importance of SAR in making investment and lending decisions (decision-usefulness) ; (ii) importance of SAR in assessing that the financial statements are free from material fraud (information risk); (iii) level of confidence that the SAR provides on the company's future viability (viability risk); (iv) level of confidence that the SAR provides on how well the company is managed (governance risk); (v) the level of confidence that the SAR provides that the company is a sound investment (investment soundness risk); (vi) level of confidence that the SAR provides that the company will meet its strategic goals (strategic risk); and (viii) the likelihood the auditors have detected

⁵ We manipulated motivation (high incentive to provide the loan versus low incentive to provide the loan) within the banker group but found this was not significant. Thus, we pool the bankers' responses.

material fraud in the financial statements (fraud detection risk). The last item was elicited on a 101 likelihood scale; all others were on a seven point appropriately labeled scale. (See panel A of Table 1 for response scales used.) With respect to the micro analysis, we focus on the SAR's use of the terms "material misstatements," "reasonable assurance," "test basis," "significant estimates" from the scope paragraph and "present fairly," from the opinion paragraph.

RESULTS

Descriptive Statistics and Between Group Analysis of Participants' Macro Expectations

Panel A of Table 1 presents descriptive statistics on the seven macro items within each participant pool as well as across participants. Participants rate the SAR as important in investing and lending decisions (mean of 5.56) as well as for assessing whether financial statements are free from material fraud (mean of 5.60). Further, the presence of the SAR provides a high level of confidence that the company will remain viable (mean of 5.05). On the other hand, participants indicate the presence of the SAR provides a relatively lower level of confidence that the company is well managed (mean is 3.48), is a sound investment (mean is 3.45), or that the company will meet its strategic goals (mean is 3.31). Thus, the assessed overall importance of SAR in facilitating decisions appears to be driven by its use in assessing information risk (whether the financials are free from material fraud) but not business risk (e.g., whether the company will meet its strategic goals). Nevertheless, participants assessed only a 50-50 chance (mean of 51.29) that auditors have detected material fraud even when the SAR was present, suggesting that while participants consider audit reports to be important to assessing whether the financial statements are free from material fraud, they are somewhat skeptical of auditors' ability to detect material fraud.

Panel B of Table 2 reports the results of a one way analysis of variance (ANOVA) to test for between group differences in the assessment of the seven macro variables. The analysis provides evidence on potential communication gaps at the macro level (i.e., differing expectations about what the SAR, taken as a whole, communicates). The analysis suggests that the null hypothesis of no between group differences is rejected for all seven macro items (all p-values < .05). Each of the main ANOVA group effects is consistent with a type I, II or III communication gap. We explore these possibilities with the LSD post hoc analysis presented in panel c of Table 1.

Users consider SAR to be more important in making investment and lending decisions than auditors. Panel A of Table 1 shows the mean importance for the auditors is 5.15, which is relatively lower than the means of 6.07 for the investors ($p = .003$) and 6.06 for the bankers ($p = .006$). The users mean importance ratings are not statistically different ($p=.980$). These results suggest auditors may not fully realize the reliance users place on the audit report.

The same pattern of results hold for the level of confidence that the SAR evokes about company management, investment soundness of a company, whether the company is likely to meet its strategic goals, and the likelihood that auditors have detected any material fraud present in the financial statements. With respect to level of confidence that SAR provides about how well a company is managed, Panel A of Table 1 shows the mean confidence for the auditors is 2.78, which is relatively lower than the means of 4.15 for the investors ($p = .001$) and 4.23 for the bankers ($p = .001$). The users mean confidence ratings are not statistically different ($p=.823$). With respect to level of confidence that SAR provides about the soundness of the company as an investment, Panel A of Table 1 shows the mean confidence for the auditors is 2.63, which is

relatively lower than the means of 4.10 for the investors ($p = .001$) and 4.55 for the bankers ($p = .001$). The users mean confidence ratings are not statistically different ($p=.209$).

Similarly, with respect to the level of confidence that SAR provides about meeting strategic goals, Panel A of Table 1 shows the mean confidence for the auditors is 2.42, which is relatively lower than the means of 4.20 for the investors ($p = .001$) and 4.23 for the bankers ($p = .001$). The users mean confidence evaluations are not statistically different ($p=.941$). Together, these results show that users have greater expectations of the SAR on a number of dimensions than currently intended by auditors and auditing standards (cf. AICPA 1988).

Finally, while auditors assess the likelihood that material frauds have been detected at 60.27%, investors and bankers assess a lower likelihood of detection at 43.33% and 44.55% respectively. As reported in Table 1, panel C, the mean detection likelihood ratings for the auditors is significantly lower than the corresponding means for the investors ($p = .006$) and the bankers ($p = .018$). The users detection likelihood ratings are not statistically different ($p=.864$).

With respect to the use of SAR for decision facilitation and the confidence that SAR triggers about future firm viability, the results show a type II gap (i.e., a gap between auditors and bankers on one hand and investors on the other). Specifically, auditors assess the importance of audit reports in facilitating user decisions at 5.31, which is not statistically different than the 5.56 assessed by bankers ($p=.554$). Investors, on the other hand, assess the importance of SAR to investing at 6.07, which is significantly higher than that assessed by auditors ($p=.006$) and bankers ($p=.081$).

Despite calls from the investment community for auditor going-concern reports, the results suggest that investors are less sanguine about the SAR's implication for future viability with a mean of 4.43 compared to auditors' and bankers' means of 5.36 ($p=.001$) and 5.13

($p=.046$) respectively. Auditors and bankers assessments are not statistically significantly different ($p=.462$).

Descriptive Statistics and Between Group Analysis of Participants' Interpretations of Specific Terms Used in Standard Audit Report

To examine participant's interpretations of specific terms used in the scope and opinion paragraphs, we focus on the SAR's use of the terms "material misstatements," "reasonable assurance," "test basis," "significant estimates" from the scope paragraph and "present fairly," from the opinion paragraph. Descriptive statistics on participants' assessments are reported in panel A of Table 2. The one way ANOVA for tests of between group assessments are reported in panel B and the LSD probe for source of between group differences are presented in panel C.

Across participants the mean dollar amount of financial statement fraud considered material was \$125,577 (approximately 2% of reported sales of \$6,500,000 and 3.5% of reported total assets of \$3,500,000). Participants expect the audit plan to detect fraud amounting to a mean of \$225,100 (approximately 3.5% of reported sales and 6.4% of reported total assets). The phrase "fairly present" provides a mean of 77.41% assurance that financial statements capture economic substance and an even higher 86.39% that financial statements conform to GAAP (paired $t=6.233$, $p<.001$).

The SAR indicates that the auditor plans and performs the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Reasonable assurance is interpreted by participants as providing a 78.96% comfort that the financials are free from material misstatements. With respect to examining evidence "on a test basis" to substantiate financial statement amounts and disclosures, participants take that to mean auditors typically examine a mean of 29.04% of sales transactions, which is higher than the mean of 25.89% of

sales transactions that they think auditors should test suggesting that they believe auditors are performing a sufficient level of testing.

Participants report a mean of 4.90 on a 7 point scale as the level of judgment exercised by management. These findings suggest participants appropriately recognize that financial statements entail a substantial degree of judgment, for instance, reflecting accounting estimates.

While the SAR provides an overall opinion on the financial statements taken as a whole, the level of assurance is likely to vary across individual accounts due to inherent limitations in the audit evidence available to address variations in the level of judgment and complexity present (Epstein and Geiger 1994; Geiger 1989). For instance, compare the assurance level that is likely for the cash account as compared to the pension liability account. In cash there is relatively little judgment in accounting for transactions and persuasive forms of evidence present such as bank confirmations and many source documents. Further, often internal controls are strong. In contrast, with pension liabilities there may be a number of complex judgments involved, especially for defined benefit plans, such as an estimation of the future rate of return for fund investments. It is difficult for the auditor to obtain evidence to corroborate the reasonableness of such estimates. The findings indicate that participants assess that the SAR provides varying assurance levels across different accounts with the level of assurance on accounts receivable at a mean of 85.62 compared to means of 78.10 and 71.86 for cash and pension liabilities, respectively.

Finally, participants assess that auditors use a mean of 8.49% of net income to determine materiality compared to the mean of 7.47% that they think auditor should use (Paired t-tests =2.297, $p = 0.023$). Thus, participants believe auditors are using a materiality level that is significantly less than what they would want them to use. .

Panel B of Table 2 reports a one-way analysis of variance comparing participants' responses to the interpretation of "fairly present" (conform to GAAP $F=11.078$, $p=.001$; capture economic substance $F=2.550$, $p=.082$); reasonable assurance ($F=2.659$, $p=.073$); test basis ($F=25.356$, $p=.001$); level of assurance on accounts receivable and cash ($p=.001$) and percent of net income auditor used ($F=.261$, $p=.771$) and should use ($F=7.899$, $p=.001$).

In panel C of table 2, we present LSD post hoc analysis of the variables that were significant in panel B. Unlike the macro expectations, the most striking observation about these micro gaps are the preponderance of type II differences (i.e., auditor and one user differ from the other user). Type II differences are present for "fairly present," reasonable assurance, and test basis.

Specifically, with respect to the degree to which fairly present reflects economic substance, auditors mean is 76.34, which is statistically identical to the 74.02 assessed by investors ($p=.548$). Bankers, on the other hand, assess this at 83.88, which is significantly higher than that assessed by auditors ($p=.074$) and investors ($p=.031$). In contrast, with respect to the degree that fairly present reflects compliance with GAAP, auditors mean is 89.17, which is statistically identical to the 91.94 assessed by bankers ($p=.388$). Investors, on the other hand, assess the GAAP compliance at 77.23, which is significantly lower than that assessed by auditors ($p=.001$) and bankers ($p=.001$).

There are type II differences with respect to the levels of assurance provided for accounts receivable and cash. With respect to accounts receivable, auditors' mean assurance is 90.13, which is statistically identical to the 94.3 assessed by bankers ($p=.234$). Investors, on the other hand, have relatively lower assurance of 71.35, which is significantly lower than that assessed by auditors ($p=.001$) and bankers ($p=.001$). With respect to cash, auditors' mean assurance is 79.4,

which is statistically identical to the 83.0 assessed by bankers ($p=.353$). Investors, on the other hand, have relatively lower assurance of 72.10, which is significantly lower than that assessed by auditors ($p=.042$) and bankers ($p=.012$). These findings suggest investors generally assess lower levels of assurance are provided by the SAR than the other participants.

There are two type III differences (each participant group differed from the others). The first is how subjects interpret “test basis” with respect to sales transaction. Auditors consider test basis to imply examining 15.16% of sales compared to 49.98% for investors and 32.0% for bankers. The auditors’ estimate is lower than that of both users ($p <.002$) and the bankers’ estimate is lower than the investors’ ($p <.003$).

Participants assessment of the percent of net income that they believe auditors should use to determine materiality produced the sole type I difference (auditors differ from users). On this variable, auditors indicate they should use 6.10 % of net income compared to 8.83% for investors and 8.81% for bankers. The auditors’ estimate is lower than that of both users ($p <.002$) but the users estimates are not statistically different ($p = .985$).

Conclusions

The standard audit report (SAR) is intended to enhance the credibility of financial information, reducing information risk for users and, thus, promoting greater level of investment and efficiency in the capital markets. However, for the SAR to have optimal value it is important that auditors and users have a shared meaning of the responsibilities and limitations of the audit function (“macro” level) and of technical terms used in the report such as “materiality” and “reasonable assurance” (“micro” level). Using a controlled experiment this study examines the congruence of interpretations of auditors, bankers, and investors at both the macro and micro levels.

The findings indicate significant differences in the interpretation by auditors and the two user groups for five of the seven macro level factors examined with generally greater expectations of auditors' responsibilities expressed by users than indicated by auditors. For instance, we found type II gaps in the assurance obtained from the audit for evaluating company management, investment soundness of a company, and whether the company is likely to meet its strategic goals. Since the audit is not designed to provide assurances in these areas, standard setters should consider revising the scope paragraph to say that an audit is not designed to evaluate these matters. Alternatively, regulators such as the SEC may wish to consider whether auditor responsibilities should be expanded.

Further, there were prevalent differences in the meaning attached to many of the micro level technical terms studied. For instance, we found type III gaps in the interpretation of "test basis." This represents widespread differences and suggest those terms should be clarified, perhaps specifically in the audit report rather than issuing a clarifying standard (e.g., SAS 69). However, most micro level differences were of the type II category, suggesting the need for a more targeted education of particular user groups rather than change in standards. The one type I gap related to the percent of net income that auditor should use for materiality. Users had a much higher percentage suggesting potential misunderstanding of the effect of materiality on audit effort.

The results also suggest a number of promising future research opportunities. We provide participants with a hypothetical situation (company, industry, background information). Our findings need corroboration in other settings and with a different sample of users. For instance, we obtain the interpretations of average investors. It is important to determine whether more

sophisticated investors such as analysts display similar interpretations of the SAR. Our data were also gathered during a recessionary period, and it would be valuable to determine if the results are similar during other, less difficult economic times. Finally, it is important to identify and test theoretical factors that account for the differences found between auditor, investor, and banker interpretations of messages contained in the SAR. Such theory can lead to the identification and testing of promising ways to mitigate the communication gaps found in this study.

Table 1
Panel A: Descriptive Statistics of Participants' Assessments of Macro Implication of Audit Report

RQ 1: MACRO ISSUES (auditors' responsibilities)	Auditor Mean (σ) n=78	Investor Mean(σ) n=43	Banker Mean (σ) n=33	Overall Mean (σ) n=154
How important is the audit report in making investment (lending) decisions*	5.31 (1.708)	6.07 (.985)	5.48 (1.202)	5.56 (1.46)
How important is the audit report in assessing that the financial statements are free from material fraud*	5.15 (1.941)	6.07 (1.142)	6.06 (.998)	5.60 (1.64)
What level of confidence does the standard audit report provide on the company's future viability**	5.36 (1.630)	4.43 (1.217)	5.13 (1.36)	5.05 (1.51)
What level of confidence does the report provide that the company is well managed**	2.78 (1.680)	4.15 (1.051)	4.23 (1.12)	3.48 (1.57)
What level of confidence does the report provide that the company is a sound investment**	2.63 (1.648)	4.10 (1.257)	4.55 (1.34)	3.45 (1.70)
What level of confidence does the report provide that the company will meet its strategic goals**	2.42 (1.599)	4.20 (1.244)	4.23 (1.31)	3.31 (1.70)
What is the likelihood that auditors have detected material fraud***	60.27 (27.41)	43.33 (34.19)	44.55 (31.68)	51.29 (31.52)

*Responses are on a 7 point scale with endpoints labeled not important (1) and very important (7)

**Responses are on a 7 point scale with endpoints labeled no confidence (1) and considerable confidence (7)

***Responses are on a 101 scale with endpoints labeled no chance that material fraud has been detected (0) and certain that any material fraud has been detected (100)

Panel B: One Way Analysis of Variance Comparing Participants' Assessments of Macro Implication of Audit Report

RQ 1: MACRO ISSUES (auditors' responsibilities)	F-stat	p-value
How important is the audit report in making investment (lending) decisions	3.955	.021
How important is the audit report in assessing that the financial statements are free from material fraud	6.414	.002
What level of confidence does the standard audit report provide on the company's future viability	5.319	.006
What level of confidence does the report provide that the company is well managed	17.615	.001
What level of confidence does the report provide that the company is a sound investment	23.466	.001
What level of confidence does the report provide that the company will meet its strategic goals	27.478	.001
What is the likelihood that auditors have detected material fraud	4.954	.008

Panel C: Post Hoc LSD Comparisons of Participants' Assessments of Macro	Participant group (I)	Participant group (J)	Mean difference (I – J)	Std. Error	P-value	*Type
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Implication of Standard Audit Report Dependent variable						
How important is the audit report in making investment (lending) decisions	auditors	Investors	-.762	.273	.006	II
		Bankers	-.177	.298	.554	
	investors	Bankers	.585	.332	.081	
How important is the audit report in assessing that the financial statements are free from material fraud	auditors	Investors	-.916	.300	.003	I
		Bankers	-.907	.328	.006	
	Investors	Bankers	.009	.366	.980	
What level of confidence does the standard audit report provide on the company's future viability	auditors	Investors	.936	.289	.001	II
		Bankers	.232	.314	.462	
	investors	Bankers	-.704	.350	.046	
What level of confidence does the report provide that the company is well managed	auditors	Investors	-1.372	.279	.000	I
		Bankers	-1.448	.304	.000	
	investors	Bankers	-.076	.339	.823	
What level of confidence does the report provide that the company is a sound investment	auditors	Investors	-1.475	.293	.000	I
		Bankers	-1.923	.319	.000	
	investors	Bankers	-.448	.355	.209	
What level of confidence does the report provide that the company will meet its strategic goals	auditors	Investors	-1.783	.285	.000	I
		Bankers	-1.809	.311	.000	
	Investors	Bankers	-.026	.346	.941	
What is the likelihood that auditors have detected material fraud	Auditors	Investors	16.944	6.063	.006	I
		Bankers	15.724	6.587	.018	
	Investors	Bankers	-1.220	7.094	.864	

*Type I = users differ from auditors

*Type II = A user and an auditor differ from other user

*Type III = All participants groups differ

Table 2

Panel A: Descriptive Statistics of Participants' Assessments of Terms used in the Standard Audit Report

RQ s: MICRO ISSUES (Terms in Audit Report)	Auditor Mean (σ)	Investor Mean (σ)	Banker Mean (σ)	Overall
What dollar amount of financial statement fraud do you consider “material” *	\$97,073 (173727)	\$242,944 (988782)	\$39,153 (61579)	\$125,577 (540,342)
What dollar amount of financial statement fraud do you expect the auditor’s plan to detect*	115,617 (199,347)	377,624 (1370569)	245,368 (1125534)	\$225,110 (937,107)
What does “fairly present” imply regarding assurance provided on economic substance of transactions**	76.34 (21.2)	74.02 (21.5)	83.88 (11.63)	77.41 (19.76)
What does “fairly present” imply regarding assurance provided conformance to GAAP**	89.17 (10.94)	77.23 (23.84)	91.94 (8.24)	86.39 (16.33)
What level of assurance is implied by “reasonable assurance”***	79.88 (16.6)	74.02 (20.65)	83.27 (17.5)	78.96 (18.21)
Regarding “test basis” what percentage of sales transactions do you think an auditor would typically examine**	15.16 (21.74)	49.98 (30.31)	32.0 (22.1)	29.04 (28.65)
What percentage of sales transactions should an auditor sample**	24.07 (27.5)	33.53 (28.16)	20.13 (19.4)	25.89 (26.47)
Regarding “significant estimates made by management” how much judgment do you think management exercises***	4.85 (1.59)	5.05 (1.28)	4.84 (1.37)	4.90 (1.46)
What is the level of assurance provided for Accounts receivable**	90.13 (11.09)	71.35 (24.33)	94.3 (10.7)	85.62 (18.42)
What is the level of assurance provided for cash**	79.40 (17.61)	72.10 (21.48)	83.0 (12.2)	78.10 (18.17)
What is the level of assurance provided for Pension Liabilities**	73.43 (23.25)	67.6 (23.06)	73.97 (18.3)	71.86 (22.19)
What percent of Net Income do you believe auditors actually used to determine materiality**	8.79 (5.11)	8.20 (3.96)	8.19 (5.225)	8.49 (4.82)
What percent of Net Income do you believe auditors should use to determine materiality**	6.10 (3.30)	8.83 (4.57)	8.81 (4.85)	7.47 (4.25)

*Responses represent dollar amounts

**Responses are on a 101 scale with appropriately labeled endpoints

***Responses are on a 7 point scale with endpoints labeled no judgment (1) and considerable judgment (7)

Panel B: One Way Analysis of Variance Comparing Participants' Assessments of Macro Implication of Audit Report

RQ s: MICRO ISSUES (Terms in Audit Report)	F-stat	P-value
What dollar amount of financial statement fraud do you consider "material"	1.555	.215
What dollar amount of financial statement fraud do you expect the auditor's plan to detect	1.028	.360
What does "fairly present" imply regarding assurance provided on economic substance of transactions	2.550	.082
What does "fairly present" imply regarding assurance provided conformance to GAAP	11.078	.001
What level of assurance is implied by "reasonable assurance"	2.659	.073
Regarding "test basis" what percentage of sales transactions do you think an auditor would typically examine	25.356	.001
What percentage of sales transactions should an auditor sample	2.622	.076
Regarding "significant estimates made by management" how much judgment do you think management exercises	.282	.754
What is the level of assurance provided for Accounts Receivable	23.082	.001
What is the level of assurance provided for cash	3.615	.030
What is the level of assurance provided for Pension Liabilities	1.046	.354
What percent of Net Income do you believe auditors actually used to determine materiality	.261	.771
What percent of Net Income do you believe auditors should use to determine materiality	7.89	.001

Panel C: Post Hoc LSD Comparisons of Participants' Assessments of Terms Used (Macro Implication) in Standard Audit Report

Dependent variable	Participant group (I)	Participant group (J)	Mean difference (I – J)	Std. Error	P-value	*Type
What does “fairly present” imply regarding assurance provided on economic substance of transactions	auditors	Investors	2.32	3.853	.548	II
		Bankers	-7.535	4.187	.074	
	investors	Bankers	-9.856	4.522	.031	
What does “fairly present” imply regarding assurance provided conformance to GAAP	auditors	Investors	11.938	2.926	.001	II
		Bankers	-2.768	3.197	.388	
	Investors	Bankers	-14.707	3.549	.001	
What level of assurance is implied by “reasonable assurance”	auditors	Investors	5.858	3.438	.090	II
		Bankers	-3.391	3.756	.368	
	investors	Bankers	-9.249	4.169	.028	
Regarding “test basis” what percentage of sales transactions do you think an auditor would typically examine	auditors	Investors	-34.811	4.917	.001	III
		Bankers	-16.836	5.345	.002	
	investors	Bankers	17.975	5.888	.003	
What percentage of sales transactions should an auditor sample	auditors	Investors	-9.454	5.187	.071	II
		Bankers	3.942	5.646	.486	
	investors	Bankers	13.396	6.262	.034	
What is the level of assurance provided for Accounts Receivable	auditors	Investors	18.784	3.200	.001	II
		Bankers	-4.156	3.479	.234	
	Investors	Bankers	-22.940	3.832	.001	
What is the level of assurance provided for cash	Auditors	Investors	7.297	3.553	.042	II
		Bankers	-3.603	3.864	.353	
	Investors	Bankers	-10.90	4.267	.012	
What percent of Net Income do you believe auditors should use to determine materiality	Auditors	Investors	-2.725	.804	.001	I
		Bankers	-2.706	.876	.002	
	Investors	Bankers	.019	.971	.985	

*Type I = users differ from auditors

*Type II = A user and an auditor differ from other user

*Type III = All participants groups differ

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Appendix 1

Review of the Expectation Gap Literature

Research on the expectation gap has proceeded by comparing the perceptions of users and auditors, holding constant the type of audit report (e.g., Libby 1979; McEnroe and Martens 2001; Best et al. 2001) or by comparing the perceptions of users under different reporting formats (e.g., Bailey et al. 1983; Best et al. 2001). Both approaches have focused on identifying gaps in the understanding of the nature and limitations of the audit function (macro-emphasis) with relatively less emphasis on users' interpretation of potentially imprecise language used to communicate audit scope and findings. That is, the research has focused on macro-differences with limited attention to micro-differences.

Libby (1979) examined differences in the messages communicated by a set of existing short form reports to audit partners and commercial loan officers. Participants rated the similarity of the messages intended by the reports and made numerical ratings on scales labeled with adjective phrases (e.g., quality of company as loan prospect, degree of judgment required by auditor, riskiness of the company, etc). Libby found no differences between the loan officers and the partners perceptions of the audit messages leading him to conclude that “fears of miscommunication of the messages intended by audit reports to more sophisticated users may not be justified.”

McEnroe and Martens (2001) examined partners and investors (sampled from the America Association of Individual Investors) perceptions about various aspects of the attest function. Participants responded to a series of questions on the attest function without the benefit of any audit report.⁶ One question asked the participants for their interpretation of “present fairly in conformity with GAAP,” and another focused on the signal of the SAR without regard to specific audit report terminology. The remaining questions asked about the conditions precedent to the issuance of SAR (i.e., an auditor should not issue SAR unless . . .). Areas of inquiry focused on integrity of accounting numbers, oversight responsibilities, viability of the entity, and the existence of fraud. The majority of both auditors and investors chose the option which indicated that the word “fairly” adds something important to the phrase (i.e., this means the same as present in conformity with GAAP and also present in a non-misleading way). Both participants tend to agree that the signal of SAR is more important than the signal conveyed by any particular terminology contained in that opinion. Significant differences between the users and auditors on the conditions precedent to SAR existed as follows: investors did not expect auditors to issue SAR unless every item of importance to them and users have been reported or disclosed, the internal controls of the audited firm are effective, the auditor has performed a public watchdog function, the financial statements are free of management and employee fraud, and there are no illegal operations conducted by the client.

An expectation gap has also been reported in other jurisdictions that used the short form report. For instance, in Singapore, Low 1984 found considerable uncertainty between analysts and auditors on the nature and purpose of the audit; in particular, they found that auditors and

⁶ The expectation gap standards had been issued for over a decade and the participants presumably were familiar with those standards and the SAS 58 audit report. However, McEnroe and Martens (2001) asked their participants to provide their responses “irrespective of any particular phraseology contained in the audit report.” Thus, they were more interested in perceptions about the attest function, not what was communicated and encoded by the audit report.

analysts differed in the area of fraud prevention, guaranteeing accuracy of the financial statements, and management effectiveness; and Best et al (2001) found the existence of an expectation gap in the area of auditor responsibilities to detect fraud, maintenance of accounting records, and maintenance of sound internal controls. User groups (bankers and investors) perceived the auditors to have more responsibilities in these areas than did auditors. Their approach was similar to that of McEnroe and Martens (2001) in that participants responded to a series of questions on the attest function without the benefit of any audit report. However, at that time the short form report was in use in Singapore. Low (1984), Low et al (1988), and Best et al. 2001 recommended a shift to the long form audit report.

Bailey et al. (1983) were the first to examine whether wording changes in the audit report can cause material differences in the perceived messages of the audit reports. In their study, they compared the short form report to the then ASB proposed audit report. They also studied the perceptions of users having different levels of audit report knowledge (recent accounting graduates who had taken the CPA exams vs. fourth year accounting students who had taken advanced accounting but not auditing). Participants performed similarity and rating tasks similar to that used by Libby (1979). Their main finding was that the proposed report shifted users'?? perceptions of the responsibility for the financial statement from the auditor to the management. They also found that more knowledgeable users placed more responsibility on management than less knowledgeable users, which suggests that users may be educated about the intended message of audit report.

Miller et al. (1990) compared bankers' reactions to the short form and the SAS 58 report. Bankers were provided either the short form or the SAS 58 report and responded to 23 questions categorized into six groups: (i) the responsibilities of management and the auditor; (ii) the

auditor's responsibility for the detection of fraud; (iii) the reliability of the financial statements; (iv) auditor communications; (v) the extent of testing and the scope of the audit; and (vi) going-concern issues. They report that bankers responding to the SAS 58 report expressed greater awareness of relative responsibilities of management vis-à-vis auditors than those receiving the short form report, although loan officers from small banks tend to assume that auditors accept more responsibility for the accuracy of the financial statements. On fraud detection, lenders from large banks perceived that the auditor was doing more testing and were more confident that the testing would detect material fraud than lenders from small banks. However, the new report eliminated this inter-bank difference. Loan officers, regardless of firm affiliation, found the new report more useful and understandable than the old report. Respondents' assessment of the reliability of the financial statements and the scope of the audit were not significantly affected by the type of the audit report or firm affiliation. These results suggest that the SAS 58 report is more understandable and better communicates the auditors' responsibilities. However, the new report did not add much clarification to the scope, nature, and limitations of the audit.

Nair and Rittenberg (1987) found differences between bankers and CPAs perceptions of the long form audit report. Bankers placed more responsibility for the financial statements on the auditors than did CPAs. They also found that auditors and users believed the long form audit report is more useful and understandable than the short form reports.

Kelly and Mohrweis (1989) found that the long form report (SAS 58) increased bankers and investors understandability of the audit report. However, the report did not alter investors' perceptions of the level of responsibility assumed by auditors. Bankers perceived auditors as assuming less responsibility under the SAS 58 report compared to the short form report. Both

groups agreed that management was responsible for presentation and disclosures in the financial statements under the new report.

The efficacy of the long form report in curbing the expectation gap has also been studied in other jurisdictions. In the UK, Innes et al. (1997) examined whether there is an expectation gap with the short form UK SAR and an expanded audit report (a UK version of SAS 58 constructed by the researchers to facilitate the investigation). Auditors and users (part time MBA students matched on age and an aptitude test score) indicated their agreement to 18 attributes of the audit. Auditors and one group of users responded based on the short form report. The other user group responded based on the expanded report. With the short form report, users and auditors differed significantly in their responses to 14 of the attributes compared to only 10 dimensions on the expanded audit report. Thus, there was only marginal support that the expanded report narrowed the expectation gap (significant differences remained in 10 dimensions). Further, the expanded SAR moved users' perceptions further away from auditors' perceptions with respect to responsibilities for the detection of fraud, although fraud was not directly addressed by the expanded report.

In the same jurisdiction, Hatherly et al. (1991) examined the effect of the expanded report on the perceptions of users (MBA students). They found that the expanded report created a halo effect. That is, the report affected dimensions not intended, including freedom from fraud, suggesting that the expanded report will not reduce the expectation gap. Monroe and Woodliff (1993) found that the expectation gap persisted under the long form report, however, education lessened the expectation gap in some areas.

In Australia, Schelluch (1996) found that the expectation gap was reduced over time under the long form audit report. However, he also found the gap persisted in the area of

financial statement reliability and the role of auditors, particularly in independence and value added to the financial statements.

Several points emerge from this review. The so- called long form or SAS 58 audit report provides clarification of the relative responsibilities of auditors and management using very precise language. That is, the report explicitly states that management prepares the financial statements and auditors audit the financial statements. While the long form report discusses the scope of an audit, the language may be imprecise and vague (e.g., test basis, reasonable assurance, etc.). Potential differences between users and auditors contained in the opinion paragraph have remained largely unchanged and may emanate from imprecise language such as the phrase “presents fairly”. The research generally finds that the long form audit report has reduced the expectation gap in the area of communicating relative responsibilities and improving understandability (e.g., Bailey et al. 1983, Miller et al. 1990). However, the report has created a halo effect (i.e., affected dimensions not intended such as freedom from fraud) and has not reduced the expectation gap regarding the scope of the audit.