WORKING PAPER

No. 95-11A February 1995

THEORY OF AUDIT REPORTING

by

Carl W. Brewer, Ph.D., CPA
Assistant Professor of Accounting
Sam Houston State University

Copyright by Author 1995
THEORY OF AUDIT REPORTING

Abstract
This paper presents a theory of audit reporting. The audit reporting process is classified into two phases: a standard and a comparison. Each phase is further analyzed in detail. The comparison (i.e., opinion formulation) aspect of auditing consists of a strength of comparison and a deviation from the standard; these concepts are then related to the auditor's difficulty in selecting an audit opinion.

SECTION I
OVERVIEW

Webster [Webster's ..., 1988, p. 1387] defines theory as:
... A systematic statement of principles involved; ...; A formulation of apparent relationships or underlying principles of certain observed phenomena which has been verified to some degree.

The primary reason for constructing a theory is to aid in the understanding of its subject matter. A "theory of auditing" then will aid in understanding how the audit process functions.

The Attest Function

Regarding the concept of attestation, Willingham and Carmichael [1975, p. 3] state:
A primary function of the public accounting profession is to render independent and expert opinions on the fairness of presentation of these stewardship reports (financial reports). In our complex, modern society this function – called the attest function – fulfills the role of adding to the credibility of representations on resource stewardship and, hence, increases the reliance which can be placed on the reports. To attest, then, means to assume responsibility for the credibility of representations.

The Audit Process

A Statement of Basic Auditing Concepts (ASOBAC) [AAA, 1972, p. 21–23] discusses the objectives of and requirements for auditing to be:
Since all audits result in the formation of an opinion or evaluation, a prerequisite to the conduct of an audit is the existence of a set of established criteria to be used as a basis for evaluation and judgment formation...
The objective of auditing is to determine the degree of correspondence between that which is being audited and established criteria...
The term auditing...encompasses both an investigative process which forms the basis for an opinion or evaluation and a reporting process in which these opinions and evaluations are communicated to the interested parties.
Since the auditor assumes responsibility for the credibility of the representations of financial statements, he is vitally concerned with the standards against which he measures that credibility.

**Objectives and Methodology**

It is the reporting phase of the audit process which is focused on in this paper. Specifically, a theory of audit reporting will be identified and analysed. The analysis will aid in further description of the theory and will relate the theory to that currently available.

**SECTION II**

**ANALYSIS OF REPORTING STANDARDS FOR AUDITING**

A search for reporting concepts must stem from the reporting obligations which give rise to the reporting requirements. A more penetrating analysis of the function of auditing will aid in identifying these obligations.

**The Role of the Auditor**

According to the professional standards of the AICPA [1992, section 110.01]:

> The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present fairly, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles.

The Commission on Auditors' Responsibilities [1976a, p. 11] states:

> The auditor enforces standards for the presentation of accounting information and evaluates the judgments made by management in applying those standards.

Note that the emphasis is on standards of presentation and an evaluation of the application of those standards.

The benefit obtained by society from the audit process is stated by ASOBAC [AAA, 1972, p. 34] as:

> ...the only tangible thing added (by auditing) is a statement of the auditor's opinion on the correspondence between the accounting information and those criteria which presumably reflect the user's definition of the desired 'quality of information.'

Emphasize "opinion," "correspondence," "quality."
Theory of Audit Reporting

Essentially auditing is a verification process whereby evidence is obtained and compared with a standard and an opinion based on the results is communicated to a set of users.

The reporting problem centers around two points: first, the identification of the standard to be used for comparison, and: second, the identification of some scale to measure (evaluate) that comparison. The latter would include some indication of the strength of the comparison and also some indication of the deviation from the standard.

The above points constitute a "theory of audit reporting:" the concepts which explain audit reporting effort. For the present these general concepts will be labeled "the standard" and "the comparison." A presentation will now be made to determine how definitive these generalizations can be.

The Standard

The initial step in the reporting process is the identification of the standard against which the evidence obtained in the investigative phase can be compared. Many attempts in this direction have been made.

Fair Presentation

Mautz and Sharaf [1961] in The Philosophy of Auditing identify fair presentation as one of the basic concepts of auditing. There is a problem with the "fairness" concept, however. As the Commission on Auditors' Responsibilities [1977, p. 2] notes: "Fairness is a quality that should underlie the preparation of financial statements, but it is not a property that can be objectively measured by the auditor."

Keeping this in mind, we continue with Mautz and Sharaf [1961, p. 158]:
...(l) concept of fair presentation is composed of three subconcepts, which, although they are closely related, require independent consideration. These are:

1. The concept of accounting propriety
2. The concept of adequate disclosure
3. The concept of audit obligation.
Each of these subconcepts can be analyzed in greater detail. Audit obligation relates primarily to the Fourth Standard of Reporting under generally accepted auditing standards (GAAS) and will be reviewed in a later section.

Accounting Propriety

Mautz and Sharaf summarize accounting propriety as being conformance with generally accepted accounting principles (GAAP), noting that GAAP can be classified into account methods and financial statement presentation. They point out the limitations of GAAP (i.e., incompleteness, circa 1961) and state [1961, p. 166] that the auditor "must never accept and apply them blindly."

The Commission on Auditors' Responsibilities [1976a, p. 15] points out that since the auditor evaluates financial statements which have been prepared within the limitations and constraints of the accounting framework he is unavoidably subject to the same constraints and limitations. This accounts for many of the difficulties of the auditor and some of the confusion between auditing and accounting problems.

Adequate Disclosure

Mautz and Sharaf indicate that adequate disclosure is directed at the extent of the financial data to be reported, including extent of detail in the statements and scope of information.

Since to evaluate the adequacy of the disclosure of risks that affect the financial statements is one of the auditor's functions [Commission on Auditors' Responsibilities, 1976b, p. 8], a definition of adequate disclosure will be helpful.

The Commission on Auditors' Responsibilities [1977, p. 9] proposes:

The standard of adequate disclosure is intended to assure the presentation of enough information and explanation to enable the user to understand the events and transactions reported on in financial statements.

This statement goes far in establishing the standard we are searching for in this portion of the paper.

The Standard

Causey (Duties and Liabilities of the CPA) [1976, p. 15] contrasts the AICPA, the SEC, and court rulings as regards the disclosure standard. The AICPA contends the standard is GAAP
and GAAS and, in the absence of specific rules, expert opinion. The SEC goes beyond this and contends that the standard is to "effectively communicate material information."

Causey [1976, p. 18] states:

The courts have now adopted the view that the most logical test of the fairness and accuracy is not whether GAAP and GAAS have been applied but whether financial disclosures tell the investor what he needs to know.

As Hill [1973, pp. 55–56] states (in an analysis of audit opinions as they relate to disclosure); "The warning itself (ie., disclosure) is the important factor, not whether the accountant has chosen to disclaim."

A synthesis of the above viewpoints leads to a conclusion that perhaps the most definitive description of the standard that we can have is reasonableness, reasonableness as to accounting methods and disclosure given the specific company and conditions.

The Comparison (Opinion)

Once the standard to be met by the financial information being reported on has been identified, the auditor is faced with perhaps his most difficult task. He must evaluate the information, giving consideration to the evidence he has obtained and "the standard." The reasoning underlying this comparison and the communication of its results, essentially the opinion, is the concern of this section.

Credibility

There is a weakness in the present comparison process. As ASOBAC [AAA, 1972, p. 61] points out:

At present we have no precise scale for measuring the degree of credibility and, therefore, the degree of belief intended by the auditor in his opinion...

This general hierarchy...the correspondence of each of these grades of opinion with degree of credibility is clear neither for the auditor nor for his user audience. Only general criteria exist for distinguishing among qualified, adverse, and disclaimed opinions.

Additional insight into the problem can be gained by examining how the opinion is formed. What are the criteria?
Generally Accepted Auditing Standards: Reporting

The standards of audit reporting promulgated by the AICPA [1992, section 150.02] are (highly condensed):

*GAAP
*Consistency
*Informative Disclosure
*Opinion

Consistency and disclosure can be combined with GAAP leaving then "GAAP" and Opinion. "GAAP" constituted "the standard" (or at least a portion thereof) and has already been considered. Consider now the fourth standard of reporting.

The Fourth Reporting Standard

The fourth reporting standard [AICPA, 1992, section 508.04] requires the auditor to express an opinion on the financial statements (or assert that an opinion cannot be expressed) and to indicate the character of the auditor's examination and the degree of responsibility he is taking. Of concern is how this opinion is made.

The AICPA [1992, sections 508.11, 38, 67, 70, 71] lists circumstances resulting in departure from the auditor's standard report. These are (highly condensed)

*Scope limitation
*Opinion based on report of other auditor
*Departure from GAAP
*Departure from principle promulgated by body designated by AICPA Council
*Consistency
*Uncertainty
*Auditor emphasis

We ignore unaudited statements since our concern is with audit effort. Also ignored are reports on comparative financial statements, quarterly financial data required by SEC Regulation S–K.
supplemental information required by FASB or GASB, and other information contained in audited financial statements. Respectively, the above departures can be classified as:

*Investigation
*Investigation
*GAAP
*GAAP
*GAAP
*Uncertainty
*GAAP (via disclosure)

Uncertainties (by consideration of FASB Statement 5, Accounting For Contingencies) can be considered a portion of GAAP. All exceptions then can be reduced to evidence or fair disclosure (includes GAAP).

In the "comparison with standard" effort, the availability of evidence applies to the strength of the comparison. Investigative exceptions then give rise to the relative inability of the auditor to make a comparison.

Fair disclosure relates to the degree of deviation from the standard, and measurement of this deviation completes the two phased analysis needed for the comparison.

Several attempts have been made to analyze the comparison process further. Most notable among these is Carmichael [1972] (Account–Research Monograph No. 1: The Auditor's Reporting Obligation).

Directing Concepts

Carmichael confined his study to what the current study has defined as "fair presentation" decisions, i.e., deviation. The thrust of his study centered on concepts relating to materiality. These "directing concepts" aim at an operative definition of materiality. The concepts are:

*Relative magnitude
*Probability
*Utility
Relative Magnitude. Relative Magnitude is basically a size test, a quantitative measure of the item under consideration.

Probability. Probability relates to the level of uncertainty inherent in statement preparation. The measurement can be made in terms of uncertainty of outcome and likelihood of error and in this manner would seem to be applicable to both phases of the comparison problem.

Utility. Utility is an analysis of the meaningfulness of the report (audit opinion) and the financial statements combined. As Carmichael [1972, p. 60] notes: "The concept of utility is the single most important reporting guideline."

The above concepts form an operative basis upon which to use materiality in the selection of audit opinions. To the degree they actually aid in the selection of opinions these concepts will be useful and increase understanding of this phase of audit reporting. To that degree they provide a more definitive description of the comparison concept.

SECTION III
CONCLUSIONS

The following theory has been proposed to describe the audit reporting process:

Audit reporting consists of two concepts:

* A **standard** against which to measure results of the investigation phase of auditing; (defined as reasonableness for the entity under consideration).

* A **comparison** of the evidence and the standard and a scale to measure and communicate that comparison. The comparison must consider two aspects: strength (ability of evidence for comparing) and deviation from standard.

The audit opinion is the current vehicle of communicating results of the comparison. Research efforts are needed in this area to refine the existing comparison scale.
BIBLIOGRAPHY


Causey, Densil Y. Duties and Liabilities of the CPA. University of Texas Press, 1976.


