The Expectations Gap: Has SAS58 Changed The Public's Perception Of The Independent Auditor's Legal Responsibilities?

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Abstract

SAS58, one of the "Expectation Gap" auditing standards, changed the wording of the standard unqualified auditor's report. The changes mandated by SAS58 do not reflect changes in the underlying audit process or in the auditor's responsibility for the audited financial statements. An experiment was conducted to determine whether these changes in the auditor's report would affect jurors' assessments of liability in an audit failure suit. No difference was found between liability assessments based on old and new forms of the report, suggesting that the changes mandated by SAS58 have no decision usefulness to report users.

Introduction

The unqualified auditor's report has been one of the most stable elements in the accounting environment. From 1949 to 1988, both the form and content of the report remained virtually unchanged in spite of criticisms that it failed to communicate either the nature of the auditor's responsibility or what an audit entails. While there were many attempts to alter the report over the years, those attempts failed due to strong opposition from the auditing profession.

In 1988, however, the report was changed. Citing the disparity between the perceptions of the profession and the public as to the responsibilities of an independent auditor, the Accounting Standards Board of the AICPA issued nine "expectation gap" auditing standards in that year (SAS53 through SAS61).¹ Of these nine standards, SAS58 superseded SAS2, the standard which had previously defined both the form and content of the unqualified auditor's report.

While both the old and new forms are presented in Appendix A, in brief, the significant differences in the SAS58 report are: (1) the addition of a title which includes the word "independent"; (2) the addition of an introductory paragraph which differentiates management's responsibility for the financial statements from the auditor's responsibility to express an opinion on

those statements; (3) an explicit acknowledgment in the scope paragraph that an audit provides reasonable assurance within the context of materiality; (4) a brief explanation of what an audit entails; and (5) deletion of a reference to consistency. In addition to the five changes noted above, SAS58 eliminated the "subject to" opinion qualifications. It is important to note that, although these changes to the auditor's report are substantial, they do not reflect a significant change in either the underlying process of auditing or in the legal responsibilities of auditors. Rather, they reflect a significant change only in the amount and type of information which is conveyed to the public. Mere changes in information reporting may, however, have significant consequences if the public deems the new information to be useful. There is cause for concern over the potential effects of changes in the standard unqualified auditor's report on the public's perception of legal liability.

Third Party Liability

One of the major concerns of the auditing profession is its increasing exposure to litigation, particularly with parties not usually considered to have privity under contract law. A major reason for the increase in lawsuits against accounting firms is that they are often

the only survivors in a multiparty action when a company fails. Under the doctrine of joint and several liability, a defendant can bear 100% of the responsibility for the economic losses sustained by a plaintiff even though the defendant may be only 1% at fault.

Although the bases for these claims are varied, many could be categorized as "third party civil damage suits based on auditor negligence" and are generally referred to as "audit failure" cases within the profession.² The outcome of these cases is dependent upon whether audit failure has occurred, which is considered to be a "question of fact" in law. Based upon the facts presented, a jury is asked to determine if the four requirements for establishing liability are present: (1) was there a duty of care owed to the plaintiff, (2) was there a breach of that duty, (3) was there damage to the plaintiff, and (4) was the breach of duty the proximate cause of the damage to the plaintiff.

The outcome of these cases is also affected by the location of the lawsuit, as state supreme and appellate courts continue to rule on accountants' duty to third parties. State case law ranges from a strict privity standard to a liberal interpretation which holds the accountant liable to all persons who might reasonably be foreseen to rely on the audit report. For example:

(1) A Florida appellate court concluded that even if third party reliance is known by the accountant, in the absence of fraud the accountant owes no duty to third parties not in privity to the audit engagement.³ The Nebraska Supreme Court has made a similar ruling,⁴ as has the Kansas Court of Appeals.⁵

(2) A middle ground privity position has been observed in decisions in Michigan,⁶ West Virginia,⁷ and Idaho,⁸ according to which independent auditors have been held liable to third parties only when the auditors knew that specific noncontractual parties were to receive their reports.

(3) California has applied liberal privity rules where auditors owe a duty of care to reasonably foreseeable plaintiffs who rely on the audit product.⁹ Likewise, Texas has held that shareholders have a right to sue an accounting firm for issuing an unqualified audit opinion on financial statements that misrepresented the corporation's financial condition.¹⁰

Research Question

In suits for audit failure the content of the auditor's report may have significant ramifications. Previous studies investigating the effects of the content of the

auditor's report have concentrated on the qualified, "subject to" report and have found it to be of virtually no use in predicting bankruptcy¹¹ or in lending decisions.¹² These studies offer little insight for predicting the effects of a change in the unqualified auditor's report on determination of liability in audit failure cases.

This paper describes a research project designed to evaluate SAS58 from a "decision usefulness" perspective. If jurors' decisions are unaffected by the required changes in the audit report, then SAS58 can be deemed to have no decision usefulness in that context. This approach to defining decision usefulness is consistent with that of the FASB in Statement of Financial Accounting Concepts no. 2 ("Qualitative Characteristics of Accounting Information"), which specifically adopts a decision making perspective for evaluating the usefulness of information.

Methodology

The analysis of variance (ANOVA) specification of the behavioral decision theory model of decision making under uncertainty is composed of three elements which interact: (1) the event (a "typical" audit failure suit), (2) the cue set (the factual information regarding the suit), and (3) the decision maker (experimental subjects in the role of jurors).

The audit failure suit employed in the experiment was a fictitious third party suit for damages against the independent auditor. The cause of the event was bankruptcy resulting from undetected embezzlement. The identity of the plaintiff, the third party, was varied such that for one half of the experimental subjects the plaintiff was an individual, and for the other half the plaintiff was a bank. This manipulation was based on speculation that juries tend to be more sympathetic to suits brought by individuals than by institutions and was intended to control for that possibility. In order to avoid issues of "joint and several" liability, the decision choices available did not allow for the awarding of partial damages.

The cue set presented to the subjects consisted of a synopsis of facts relevant to the typical audit failure suit, and included: a description of the nature of a civil damages suit, the type of remedy available, the amount of damages sought, the names of the plaintiff and respondent, the reasons for the audit, the duration of relationship between the parties, the act which resulted in the damages, the person who perpetrated the fraud, and the financial results of the fraud. For half the subjects, the cue set included the SAS2 form of the auditor's report; the remaining half received the SAS58

unqualified audit report in their cues. The experimental document (bank plaintiff version) is included in Appendix B.

The decision makers (surrogate jurors) consisted of 180 students enrolled in psychology classes at a nontraditional urban undergraduate college. An exit questionnaire indicated that these students ranged from 21 to 50 years of age, were from varied socio-economic and racial groups, and had varying amounts of business and legal system experience. No information suggested that the subjects differed demographically from typical jurors.

In summary, a 2X2 factorial design was employed to test three null hypotheses: (1) on average, liability assigned in the audit failure case will be equal for the SAS2 and SAS58 unqualified audit reports; (2) on average, liability assigned will be equal for the individual and bank plaintiff cases; and (3) on average, liability will be equal for each type of report by each type of plaintiff (there will be no interaction between type of audit report and type of plaintiff). ANOVA was the method of analysis.

Results and Conclusions

No differences in average liability assessments between experimental groups were observed. Subjects' decisions were not affected by type of audit report and/or type of plaintiff.¹³ While additional research is needed, in the interim, our results suggest that the changes in the unqualified auditor's report mandated by SAS58 have no decision usefulness in the context of third party audit failure suits. SAS58 does not appear to have measurably reduced the expectation gap between auditors' and users' perceptions of the audit product. As auditors are increasingly held responsible for third party losses, it is evident that changes in the audit product which are merely cosmetic are unlikely to control auditors' exposure to professional liability.

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13. Full results are available from the authors.

Appendix A: SAS2 Form Of Unqualified Audit Report

To the Board of Directors
Widget Corporation:

We have examined the balance sheet of Widget Corporation as of December 31, 1987, and the related statements of operations, stockholders' equity, and changes in financial position for the year then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the 1987 financial statements referred to above present fairly the financial position of Widget Corporation as of December 31, 1987, and the results of its operations and changes in financial position for the year then ended, in conformity with generally accepted accounting principals applied on a consistent basis.

Collins & Company

Denver, Colorado
February 1, 1988

SAS58 FORM OF UNQUALIFIED AUDIT REPORT: INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying balance sheet of Widget Corporation as of December 31, 1987, and the related statements of income, retained earnings, and cash flows for the year ended. These financial statements are the responsibility of the Widget Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Widget Corporation as of December 31, 1987, and the results of its operations and cash flows for the year then ended in conformity with generally accepted accounting principles.

Collins & Company

Denver, Colorado
February 1, 1988

Appendix B: Experimental Document

You are a member of a jury. The case which you are being asked to decide is a civil suit. This means that the party who is bringing the suit is referred to as the plaintiff, not the prosecutor, and that the party who is being sued is referred to as the respondent, not the defendant. It also means that the only remedy which you can grant the plaintiff, should you find in its favor, is money. You will not be asked to determine whether or not the respondent should go to jail, nor will you be allowed to sentence the respondent to jail even if you feel it would be appropriate. The question of jail would be presented to a different jury at a different trial, a criminal case.

The case which you are being asked to decide is the case of 1st Natl Bank versus Collins & Co. 1st Natl Bank, the plaintiff, is suing Collins & Co., the respondent, for \$750,000 in damages. This is a complicated

case, as most civil damage cases are, and you have had to pay close attention to the testimony of the witnesses. You are about to be sent to the jury room to deliberate your decision. To aid you in your deliberation the attorneys have summarized the pertinent facts of the case as follows:

1. To protect the public from misleading statements about the financial condition of a company, the Securities and Exchange Commission requires that all companies whose stock is publicly traded must hire an independent auditor. It is the job of the independent auditor to offer an opinion as to "the fairness of the financial statements." Since Widget Corp.'s stock had been traded on the New York Stock Exchange since 1976, Widget Corp. had been hiring an independent auditor since that date. From 1976 to 1985 the Widget Corp. audit was performed by Douglas & Co., a reputable firm. For 1986 and 1987 Collins & Co., the respondent, were the auditors. All parties agree that it is not unusual for companies to change auditors every few years, in fact it is recommended, so the change in auditors is not seen as significant.

2. John Smith had been employed at Widget Corp. from 1981 to 1988. John had been considered a valued and trusted employee and had always received excellent ratings on his job performance reviews. However, John was secretly a compulsive gambler and in 1984 began embezzling funds from Widget Corp. to support this habit. Unfortunately for John, in 1988 a co-worker happened to observe his losing at the roulette tables in Las Vegas. A few days later the co-worker happened to mention the event to John's boss and commented, "I wonder where he gets that kind of money to lose?" As a result of this comment an investigation was conducted which ultimately disclosed the embezzlement. John was convicted of the crime and is currently in jail; however, he was unable to repay any of the embezzled funds. As a result of the embezzlement, Widget Corp. was unable to meet its financial obligations and was declared bankrupt late in 1988.

3. Early in 1988, before John's embezzlement had been detected, 1st Natl Bank loaned \$750,000 to Widget Corp. Prior to making the loan, 1st Natl Bank obtained the latest publicly available financial statements of Widget Corp, the financial statements dated 12/31/87 which had been audited by Collins & Co. Based on the information contained in the financial statements, 1st Natl Bank decided to make the loan. Unfortunately, as was described in the preceding paragraph, Widget Corp. was declared bankrupt late in 1988 and as a result of the bankruptcy 1st Natl Bank's loan to Widget Corp. became worthless.

Based on the facts, the attorney for 1st Natl Bank argues that Collins & Co. were negligent in performing their audit of the 1987 financial statements of Widget Corp. The attorney argues that Collins & Co. should have discovered the embezzlement by John Smith. The attorney reminds you that he has presented four expert witnesses who state that this is so, "Collins & Co. should have discovered the theft." Further, the attorney argues that if the embezzlement had been detected and reported by Collins & Co., 1st Natl Bank would not have made the loan and would not have lost \$750,000. Therefore, the attorney urges you to hold Collins & Co. responsible for the loss suffered by 1st Natl Bank and award them \$750,000 of damages to be paid by Collins & Co.

Based on the same facts, the attorney for Collins & Co. argues that his clients were not negligent in performing their audit of the 1987 financial statements of Widget Corp. The attorney argues that an independent audit is not intended to search for an incidence of employee theft and would not necessarily discover an embezzlement of the type perpetrated by John Smith. The attorney reminds you that he has also presented four expert witnesses who state that this is so, "Collins & Co. were not negligent merely because they failed to discover the theft." Further, the attorney argues that this claim is supported by the opinion letter which was issued with the 1987 financial statements of Widget Corp and read by 1st Natl Bank before making the loan.

(The next page is a copy of the opinion letter-please read it at this time.)

The attorney urges you not to hold Collins & Co. liable for the loss and to award no damages.

You must now decide whether or not Collins & Co. owe \$750,000 to 1st Natl Bank. Please record your decision.