SIGNS, CODES AND COMMUNICATION:
THE SEMIOTICS OF AUDIT REPORTS

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Abstract

The range of issues which have come to be labelled the "Expectations Gap" have been the focus of much debate in the auditing literature, both scholarly and professional. The empirical literature has focussed on establishing the *existence* of the gap; while the professional and/or analytical literature has been largely normative, and concerned with reducing or eliminating the gap. This paper takes a different approach: it seeks to develop a theoretical model to explain the communication process of audit reporting, and from this, reasons *why* the gap would exist. Initially, it is established that auditing is a communication process. A semiotic model of communicative activity, developed in literary theory to analyse written texts, is applied to the audit report. Analysing the audit report along these lines, the inevitability of communication or expectation gaps emerges.

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Introduction and Motivation

Auditing adds credibility and substance to financial statements that might otherwise be the subjective disclosures of corporate management. This attestation as to credibility takes place in a written audit report, which is communicated to financial statement users via the annual report. Hence, audit reporting is a communication process, with the medium of communication being a written text. It would seem, therefore, that it may be fruitful to draw upon communication theory to adumbrate this process.

Communication theory attaches central importance to the role of meaning in the communication process: communication involves the encoding and decoding of messages, with a code being a shared system of meaning. If senders and receivers of messages have access to the same code, then meaning is generally shared and communication takes place with some resultant effect on the behaviour of the receiver. A code is "a system of meaning common to the members of a culture or sub-culture. It consists of both signs and rules or conventions that determine how and in what context these signs are used and how they can be combined to form more complex messages" (Fiske, 1990:19). Arguably, accounting and auditing are a code belonging to the sub-culture of financially literate people.

Auditors are the senders and financial statement users (hereafter referred to simply as users) the receivers, in the audit reporting communication process. The purpose of this paper is to use a model of communication derived from literary theory to analyse the potential for shared meaning (and hence effective communication) of the messages

conveyed by audit reports, and also the extent to which those meanings may be affected by contextual factors.

The study of meaning in auditing is timely, because increasingly, over the past several decades, there has been debate about the meaning, purpose, content and effect of the statutory audit report of corporate financial statements. The rubric "Audit Expectations Gap" (hereafter AEG) has been applied to much of this debate. In part, the AEG has been defined as "differences in attitudes and beliefs between auditors and the public about … the message(s) conveyed by audit reports" (Woodliff, 1995:1). Differences attributed to audit report message(s) by auditors and users are thought of as a lack of shared meaning and thus a communication problem. That the AEG has arisen as a result of miscommunication is a common contention of the AEG literature; for example, the Cohen Commission (AICPA, 1978) criticised the inadequacy of the auditor's report in conveying messages about the auditor's function. In spite of this, there has been virtually no use of a framework from communication theory to examine any of the issues arising from the AEG. Instead, the thrust of the literature has been largely atheoretical and has simply made calls for "improved communication" by the profession with "the public".[1]

However, the AEG persists (see, for example, Jaenicke and Wright, 1993; Epstein and Geiger, 1994; Woodliff, 1995) despite decades of "education" of the public and both subtle and substantial changes in audit report wording. It is still represented as a problem caused by the public's "misunderstanding" of the audit process, and there are still

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[1] The terms "public" and "society" are used interchangeably in the literature. Porter (1993:49) defines "society" as "the population at large, inclusive of auditees and users of financial statements, but exclusive of auditors. It thus co-incides with all non-auditors. This is consistent with the meaning ascribed to the word in the Cohen Commission Report [AICPA, 1978]. The Cohen Commission also used the term 'the

repeated calls from the profession (for example, ASCPA and ICAA, 1994) and academia (for example, Woodliff, 1995) for yet more education of the public.

In examining audit report communication, it is useful to make a distinction between naïve or unsophisticated users, and financially sophisticated users, those to whom audited financial information is directed,[2] rather than an undifferentiated "public". These individuals form part of the financially literate "sub-culture". Careful interpretation of the empirical AEG research shows that there is not one gap, but rather a variety of gaps between the different parties to the audit process (see, for example, Porter, 1993; Humphrey, et al., 1991, 1993; Woodliff, 1995). The largest gap is said to exist between sophisticated groups (auditors, managers, accountants, bankers, financial analysts) and general public users (private shareholders and students). This gross difference may be largely explained by differential knowledge levels and may be reduced by appropriate education. The fact that gaps still exist between the sophisticated groups, who do have a significant level of financial education, implies that the communication process is more complex and subtle than has previously been assumed in the literature. Arguably, the answer lies in the socially constructed nature of the meaning of auditing and audit reports. As humans filter and process data according to their individual experience, meaning is always context-dependent and never socially neutral. The application of a semiotic model

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public' to mean the same thing". The concept is therefore broadly and somewhat vaguely defined, and of limited practical use.

[2] Statement of Accounting Concepts SAC 3 "Qualitative Characteristics of Financial Information" states that "the ability of users to understand financial information will depend in part on the way in which the information is displayed. General Purpose Financial Reports ought to be constructed having regard to the interests of users who are prepared to exercise diligence in reviewing those reports and who possess the proficiency necessary to comprehend the significance of contemporary accounting practices" [para. 36]. Further: "It should be borne in mind that professional advice can be obtained by users of General Purpose Financial Reports" [para. 37].

of communication to audit reporting in this paper helps to explicate some of the variables which may be driving these contesting meanings.

Auditing as a Communication Process

The end result of the audit process, the auditor's report, communicates to users something, depending on the opinion expressed therein, about the credibility of the financial statements. It is a comment upon their validity, or degree of correspondence with the underlying economic "reality". What do we mean by communication? As a subject of study, it has been approached from many disciplines: literary theory, linguistics, philosophy, psychology, engineering, sociology and media studies to name a few, indicating its pervasive importance to society. Despite the differing emphases and theoretical frames of reference employed by the different disciplinary approaches to communication, certain elements are regarded as fundamental to the process of communication. These are: a sender, a receiver, a channel, a message and an effect. For any communication to take place, a sender initiates a message, then encodes it (translates it into a signal, such as writing). The message is then sent (transmitted) through a channel or medium (such as a report) to a receiver who decodes the message. In decoding the message, the reader interprets it in some way, with a consequent behavioural or affective response. The analyses to which this process[3] have been subjected may be divided into two major schools of thought.

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[3] The word 'communication' is a noun, but it refers to a complex process rather than an object. The concept of process is one of activity/dynamism: "any phenomenon which shows a continuous change in time" or "any continuous operation or treatment" (Berlo, 1960:23). Two related problems are present in discussing the process of communication: (i) "by so doing, the dynamic of the process is arrested … the interrelationships amongst elements are obliterated … A word is only a representation of a thing, not a thing; and (ii) in using language to describe a process, we must choose certain words …[and] freeze the

The two schools of thought have been dubbed "process" and "semiotic" by Fiske (1990). The process school[4], focussing on the transmission of messages, stems mainly from psychology and sociology, while the semiotic school, concerned with the production of meaning through sharing and exchange, is more closely associated with the arts, linguistics and literary theory. Process-type models are largely derived from the basic linear model of Shannon and Weaver (1949). Figure 1 shows this model, as applied to the audit reporting process.

PLACE FIGURE 1 ABOUT HERE

After the completion of the audit process, the auditor decides on the message he or she would like to report reader to receive. This message must be selected from, or encoded within, a limited number of choices of wordings. Primary transmission of the message is in the form of the printed auditor's report attached to the financial statements in the annual report of the auditee company. The reader receives the report and is presumed to read it. In reading the report, the user interprets and decodes the message in some way, resulting in some kind of judgment about the validity of the financial statements. Such a judgment may or may not result in a subsequent behavioural response, i.e., a decision or action.

In relation the AEG, such process-type models have been implicitly applied in the existing literature, which typically identifies the AEG as a communication problem: the

physical world in a certain way" (Berlo, 1960:25). This limitation needs to be borne in mind in the subsequent discussion.

[4] The term "process" used here, adopted from Fiske (1990), is in general use. However, the qualification made in the preceding footnote needs to be noted. *All* models of communication attempt to describe a complex process; this category of model tends to "freeze reality" in a particular way, that, by describing communication as a linear process of transmission.

audit report is not worded adequately so as to convey the message intended by the auditor in respect of the auditee's financial statements. Although a useful starting point, such a model is partial and simplistic. The assumption is that the meaning encoded and the meaning decoded will be the same, unless there has been some noise (or encoding or decoding "error") in the communication process. This implies that there is something "intrinsic" or "absolute" about the meaning of the message: the meaning is *in* the message, rather than being the product of professional judgment and interpretation interacting with contextual factors for the auditor, and as a similar interaction process affected by contextual factors for the user.

Semiotic Models of Communication

Semiotic models of communication permit a richer and more complex view of human communication. They "focus on the manner in which cultural meanings are produced, on the producers, and on the processes of the production of meaning. They give equal attention to the structures within which meanings are consumed, and on the consumers, and on the processes of consumption of meaning. Above all, [they] insist on seeing the totality of structures, of the whole system, of the interconnectedness of all the processes (Kress, 1988:11).

Semiotics, as a discipline, is concerned with signs and the way they function systematically to convey meaning. A sign is something physical, perceivable by our senses; referring to something other than itself, and depending upon a recognition by its users that it is indeed a sign. The focus in semiotics is not on the accuracy or efficiency of the transmission process, but rather on the works of communication themselves; that is,

the messages or texts. Meaning is not an absolute, intrinsic to the text, but is produced by the interaction of people with the texts. The role of the receiver is less passive than in process models. The term "reader" is preferred, because that person must actively engage with the text, bringing to bear their own experience, knowledge and attitudes to produce their meaning. Communication is thus seen as the generation of meaning through a process of exchange.

Semiotic models of communication are basically triangular (in comparison to linear process models). Influential models are those of Saussure (1975), Pierce (1985), Ogden and Richards (1923), Morris (1938), and Barthes (1968). Common to these models, a sign is composed of two aspects. The signifier is the physical existence of the sign (e.g. words on a page) and the signified is the mental concept that the signifier creates. The sign relates to external reality by a process called signification, and meaning is generated as a product of the structural interrelationships of signs. Signifiers are used to structure reality in order to understand it. They are man-made constructs, a product of the culture to which people belong, and part of the system that members of the culture use to communicate with each other.

Before applying a semiotic model to audit reporting, let us turn to a brief consideration of codes, which are the means of grouping and structuring signs.

Codes and Conventions

The term "code" has been introduced in previous sections. The process models of communication speak of "coding" and "decoding" a message; while to the semiotic

school it is a concept of major importance. A code is a system or arrangement of signs. Fiske (1990:19) identifies a code as "a system of meaning common to the members of a culture or sub-culture. It consists of both signs (i.e. physical signals that stand for something other than themselves) and rules or conventions that determine how and in what context these signs are used and how they can be combined to form more complex messages." Codes are therefore combinations of signs used to convey meaning. Language itself is "the most highly developed and most finely nuanced cultural code" (Kress, 1988:15).

Saussure identified two ways of structuring signs into codes. The first way is by paradigm, the set of signs from which a choice may be made; the second is by syntagm, the message into which the signs are combined. All messages involve a selection and combination of signs; meaning is generated through the particular choice of selection and choice of combination. The auditing paradigm is the vocabulary set available (largely mandated by standards) to auditors to choose from for report formulation, in particular the opinion types. The syntagm is how they are combined to form an individual audit report.

Saussure's theories were further developed by Barthes (1968, 1973) and Guiraud (1975), who were motivated by the fact that the same sentence/syntagm (e.g., the auditor's opinion) may have a different meaning to different people in different contexts. Meaning is therefore generated through the interaction between a reader and a text and is contextually bound.

Accounting and auditing are clearly a code, belonging to the "sub-culture" of financially literate people. Accounting is the system into which signs referring to

economic events are organised, and auditing is an even more specialized code which refers to the degree of correspondence between the accounting code and the economic events it purports to represent.

The concept of "convention" is also important; that is, the agreement between members of shared background about how and in what context signs are combined to form codes. The auditing system of meaning is governed by convention (generally accepted auditing principles) and rules (Standards and legislative requirements). Indeed, the Australian profession's Auditing Guidelines have recently been "codified" into binding Standards.

Auditing can be viewed as a representation code, which is one that produces a text (in this case, an audit report) (Fiske, 1990). A text is a message with an existence independent of the communicator and the situation, and conveys information and ideas about things that are absent. A text such as an audit report is composed of symbolic signs (words) referring to the attributes of the financial statements.

Another insight may gained by applying the idea of elaborated and restricted codes (Bernstein, 1964) to auditing. A restricted code is common in a closed community (for example, the profession). The vocabulary of a restricted code is smaller and its messages are highly predictable (the standard wording and limited range of opinions in an audit report). To interpret a restricted code and share meaning depends on the commonality of assumptions, interest, background, experience and incentives. The parties to the communication must know the rules and conventions by which signs are selected and combined. If a reader/user is the product of a different background experience, then what Eco (1965) refers to as aberrant decoding will take place, and the

meaning produced will be different to the one intended. Anecdotal evidence supports the

'jargon' of accounting and auditing functioning as a restricted code. For example, a

Department of Trade investigation in the U.K. complained:

> "the sparse terminology employed by auditors has reached a stage of evolution
> when it may be described as hieratic. Such language may undergo a further stage
> of evolution as it frequently does in the law, when a phrase becomes a 'term of
> art' conveying to a lawyer a precise meaning which is quite different from its
> apparent meaning to a layman. Hieratic language suffers from every possible
> deficiency, being neither comprehensible as ordinary speech, nor adequately
> defined to a specialist."[5]

The Production of Meaning in Audit Reporting

The generalised semiotic model of communication amalgamates the basic

similarities of various models. These models contain a number of constituent elements,

the interaction of which results in the generation of meaning. The message/text is not part

of a linear process but one element in a structured[6] relationship, whose other elements are

the thing to which the text refers and the individual producer/reader. The model is a

dynamic one with constant interaction taking place between the elements. The

message/text[7] is a construction of signs, organised into a code, which is read by the

receiver/reader. Reading is the active process of decoding/discovering meaning which

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[5] Department of Trade Inspectors, (1979) *Report of Investigation Under Section 165(b) of the Companies Act 1948 into the affairs of Peachey Property Corporation Ltd* (London: HMSO), p.156., cited in Flint (1988).

[6] Semiotic models are also referred to as "structuralist" models (O'Sullivan, et al., 1983:42). Williams (1976:253) identified "structure" as a key term in modern thought, and traces its etymology. From an original meaning of the manner of construction of buildings, the word came to have figurative applications, with the most important being that of "the mutual relation of constituent parts or elements of a whole as defining its particular nature" (p.253). In other words, the complex whole which is communication, needs to be viewed in terms of the mutual relations, i.e., interactions between its elements.

[7] Although the two terms "message" and "text" may be used interchangeably, and frequently are, it is possible to differentiate them. According to O'Sullivan et al., (1983:238), "text" refers to "a message that has a physical existence of its own, independent of the sender and receiver, and thus composed of representation codes [e.g., an audit report] … [it] consists of a network of codes working on a number of levels and is thus capable of producing a variety of meanings according to the socio-cultural experience of

occurs when the reader interacts with the text. The model is shown applied to audit reporting.

PLACE FIGURE 2 ABOUT HERE

Iser (1985) provides a detailed consideration of the interaction between a reader and a text:

> "If the virtual position of the work is between text and reader, its actualization is clearly the result of an interaction between the two, and so exclusive concentration on either the author's techniques or the reader's psychology will tell us little about the reading process itself … Despite its uses, separate analysis would only be conclusive if the relationship were that of transmitter and receiver, for this would pre-suppose a common code, ensuring accurate communication since the message would only be travelling one way. In [literary] works, however, the message is transmitted two ways, in that the reader 'receives' by composing it. There is no common code – at best one could say that a common code may arise in the course of the process" (p.190).

Iser sees the differences between reading and interpersonal communication lying in (i) conditions and (ii) intentions. With respect to conditions, "an obvious and major difference between reading and all forms of social interaction is the fact that with reading there is no face-to-face situation. A text cannot adapt itself to each reader it comes in contact with. The partners in a dyadic interaction can ask each other questions in order to ascertain how far their images have bridged the gap of inexperienceability of one another's experiences. The reader, however, can never learn from the text how accurate or inaccurate are his views of it" (p.191). With respect to intention, it is not as specific: "…the codes which might regulate this [reader/text] interaction are fragmented in the text,

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the reader". A "message", on the other hand, is less problematic, and has the simple sense of "that which is transmitted" (p.238).

and must first be reassembled or, in most cases, restructured before any frame of reference can be established" (p.191).

> "It is the gaps, the fundamental asymmetry between reader and text, that give rise to communication in the reading process; the lack of a common situation and a common frame of reference corresponds to the 'no-thing'[8] which brings about interaction between persons … The imbalance between text and reader … is undefined, and it is this very indeterminacy that increases the variety of communication possible" (Iser, 1985:192).

Paradoxically, it is the *gaps* or asymmetry which provide the impetus for interaction and/or communication to take place, yet at the same time the inability to experience another's experience means that there can never be full communication. This can be seen in audit reporting: the information asymmetry between shareholders and management leads to the demand for audit reporting; yet audit reports are not read in the same way by readers as auditors (i.e., there are communication or "expectations" gaps).

The process of creating meanings will be influenced by the socio-cultural position and experiences of the reader, the referent of the text (that to which the text refers),[9] and the context in which the act of communication takes place.

In applying the generalised semiotic model of communication to auditing, the producer is obviously the auditor, and the readers include financial statement users. The text or message which is produced is the audit report. The referent, that thing to which the text refers, is not the financial statements themselves, nor the underlying events and transactions represented in the financial statements. Rather, the audit report is an opinion

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[8] 'No-thing' is a term coined by R.D. Laing (1968) to describe the basis of inter-personal relationships. No person can experience another person's experience, so human contact depends on continually "filling in" a central gap or "no-thing" in our experience.

[9] Some writers (e.g., O'Sullivan, et al., 1983; Fiske, 1990) use the term "external reality" as a description of the referent, in the sense of that to which a text refers that is other than itself. However, the notion of "external reality" is somewhat problematic in accounting and auditing. What is referred to in the audit report is not "reality" but rather an abstract judgment on how well "reality" has been represented in the financial statements. This point is considered further later in this paper.

on the credibility or validity ("truth and fairness") of the assertions made in the financial statements. That is, it is an opinion on the correspondence between the financial statements and the underlying "economic reality".

The meaning of audit report is generated through interaction of the elements of the model. The following discussion traces the paths of the relationships in the model.

For the auditor, a judgment about the validity of the financial statements is formed (as a result of the audit process and based on the audit evidence obtained) and translated into an audit opinion, on which the auditor, as a professional, may reflect as to its appropriateness. At the same time, the auditor's knowledge of the categories of audit opinions, and the circumstances to which they may apply, may influence with judgment of the validity of the statements, depending on whether those circumstances are present.

For the user, the type of audit opinion may affect their judgment of financial statement validity; for example, a qualified opinion may mean less valid statements. Alternatively, a judgment about a company's statements (for example, they are of dubious validity, based perhaps on media reports) may influence the meaning ascribed to the audit report (e.g., a clean report may mean "less" where there is a perception of low statement validity).

The process of the production of meaning is seen as continuous and dynamic. Meaning is culturally and historically located, and may change over time (Fiske, 1990). It is not a constant. [10] In the short term, it is also possible that meanings held by both auditors and users will affect their validity judgments and/or opinion formulation process in a subsequent financial period.

It is also important to note that the interactions between the elements will be moderated by context: the statements and the report do not exist in a vacuum, and individual judgments will be influenced by many factors. For instance, judgments of statement validity may depend, *inter alia*, upon what industry a company is in, and its actual financial position and performance; and the auditor's opinion formulation process may be influenced by their degree of independence from the auditee.

Previous studies of the AEG, while not conducted within an explicit theoretical framework, may be viewed as based implicitly on a process-type model of communication. That is, the emphasis is on how best to transmit the message to the receiver (e.g. by altering the wording of the audit report) and the receiver (generally through the process of "educating the public"). To a large extent, the contexts of audit reports and how they affect the interpretations of auditors and users, have been ignored. It is argued that context and its effect on interpretation of audit reports could play a significant part in understanding the AEG. The application of the semiotic model is fruitful in providing a new approach to analysing the AEG.

There are two main aspects to the importance of context in audit reporting. One is that there is only a limited amount of insight to be derived from examining the meanings of relative wordings of audit opinions in isolation (for example, as in Karvel, 1979 and Houghton and Messier, 1991). It might be argued that an audit report cannot be considered in isolation from its referent, as they are both part of a company's annual report (or, at the very least, such an examination is of limited external validity). The understanding of the message in the audit report is generated through the interaction of

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[10] This is demonstrated in relation to audit reporting in the monograph of Sikka, et al., (1992), which demonstrates how the "commonsense" understandings of the audit function were always primarily

audit report, the user, and the user's assessment of the validity of the financial statements, the three elements of the model.

The other aspect of context is that within which the human element of the model operates. A major factor is the producer/user distinction. Auditors, and the various user groups, are employed in different occupations, and as such, use audit reports in respect of different decisions.[11] Those decisions are made in the context of varying economic incentives.

In making a decision as to the type of audit report to issue, the auditor is subject to various contextual factors relating to the practice of his/her occupation. These include the regulatory framework (professional accounting and auditing standards and Corporations Law) which must be complied with; factors affecting the quality of the audit (e.g., whether the firm is Big Six or not, and whether the firm has industry specialization); and various factors affecting the auditor's independence (e.g., the length of tenure with the auditee, the percentage of the fee base the client represents, and the amount of non-audit services provided to the auditee).

An important contextual factor for both auditor and user is the economic positioning/strength of the auditee company. It is partly from an assessment of this that they make their judgment as to the validity of the financial statements (the referent of the model). However, that assessment is derived in different ways by the auditor and the user. For the auditor, who has access to the detailed financial and non-financial records of the company, it is derived through the audit process of sampling and verification. A user does

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concerned with fraud detection, but have changed over time.

[11] Another part of the producer/user distinction is the factor of the parties' relative levels of financial sophistication. Clearly, auditors are expert at, and highly sophisticated with respect to auditing, relative to non-auditors. This has been claimed (e.g., Porter, 1993; Woodliff, 1995) as a major component of the AEG.

not normally have access to such records and must make a judgment based on other sources of information.

The second important aspect of the model is the emphasis on interpretation. It may be argued that audit reporting is a one-way linear communication process: the auditor encodes a particular message about the company's statements in the form of an audit opinion, which is then transmitted to users via the audit report in the annual report (or re-transmitted via the media). It is not a two-way exchange.[12] However, the semiotic model emphasises that *both* sender and receiver must undergo a process of interpretation, subject to various contextual factors (as described in the preceding paragraphs) to come to their respective understandings of the audit report. Interpretation is just as much a factor for auditors as it is for users, in arriving at the "message" to be communicated. Interpretation is required not just in making sampling decisions and analysing results, in the appropriate application of accounting policies, and in determining the appropriate opinion to be issued, but even at the broader level of agreement or understanding of the objective of the audit function. [13] Having emphasised the importance of context in the determination of the meaning of audit reports, let us now turn to the three elements of the semiotic model.

However, as previously noted, different understandings of audit reporting are present across financially sophisticated user groups.

[12] There is no role for feedback in the transmission of the audit report in the sense that once the report is issued, a receiver then cannot influence the sender to change it. However, feedback may be viewed as having a more general role over a longer time frame. For example, perceived "audit failure" may lead to dissatisfaction on the part of users expressed in the media and in direct submissions to regulatory agencies, leading to changes in the regulations governing audit reporting. Iser (1985) argues that reading (e.g. of an audit report) is a two-way process because the reader "re-composes" the text on receiving it.

[13] That is, should the audit take a "holistic" approach, with "truth and fairness" being the overriding consideration; or, alternatively, is it believed that a "true and fair view" would prima facie be achieved by compliance with accounting rules and regulations? Deeper consideration of this point is outside the scope of this paper. Higson and Blake (1993), amongst many others, provide further discussion of this point. Note, however, that with the accelerating pace of international harmonization of accounting standards, this debate is likely to take centre stage again.

The Individual - Producer/Reader

At the apex of the semiotic model is the human individual: the auditor who produces the message in the audit report and the users who read it. These individuals are heavily influenced in the determination of their meanings by the context in which they exist and operate. Focussing on sophisticated users, a further distinction may be made between managers (financial statement preparers) and other user groups.

Financial managers/executives and auditors are both parties to determining the final content of the financial statements and hence the audit report. "In preparing financial statements, managers decide, subject to certain legal constraints, which accounting methods will be employed and how items will be valued. Where auditors disagree with managers' decisions it can be assumed that negotiations are entered into with the aim of resolving the disagreement" (Craswell, 1985:101). If the disagreement with management is resolved,[14] then a clean report would be issued; if not, then the audit report would have to be qualified. Managers are therefore a party to, and have a significant influence on, the formation of the audit opinion. There is not a clear linear process of communication between auditors and management.

Turning to other sophisticated user groups, and their decision context (the purpose for which they require audited financial information); the lending decision of bankers represents the perspective of debtholders, while the investment decision of financial analysts represents the perspective of equityholders. Equityholders and debtholders in an agency relationship are subject to differential economic incentives and have access to different information sources in making their decisions. Bankers are able to command

private information from corporate clients, while for financial analysts the audited financial statements represent the primary information source (Bouwman, et al., 1987); therefore they are likely to differ in the significance attached to the monitoring function culminating in the audit report.

The Text – Audit Report

The audit report is the text containing the message about the validity of financial statements. The form of the audit report is standardised, and specified in AUS 702, *The Audit Report on a General Purpose Financial Statement*. The major variability within the audit report is the form the audit opinion takes. The intention of regulators and auditors is that the different types of audit opinions convey different messages about the validity of financial statements; that is, they have different meanings. An audit report may be qualified for scope limitation, inherent uncertainty and disagreements with management; and the reasons for, and effects of, these qualifications must be set out in the audit report. In these circumstances, there is less likelihood of misunderstanding by sophisticated users of the meaning of this type of audit report. Significant differences in meaning are more likely to arise in respect of clean opinions. Because they are by far the most common type of opinion, attached to a wide variety of companies in differing industries at different positions along the continuum of corporate financial health, they send a signal more ambiguous and subject to varied interpretation than qualified opinions.[15]

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[14] Kinney and Martin's (1994) review of audit-related adjustment studies found that auditors' adjusting entries had an overwhelmingly negative effect on pre-audit net earnings and net assets, hence countering bias present in management's assertions.

[15] Litigation against auditors is generally associated with a company failure which was not flagged by a qualified audit report (e.g., Kennedy & Shaw, 1991). The AEG argument is that the action against auditors results from users misunderstanding the meaning of a clean audit report; that is, the current litigation "crisis" is symptomatic of a failure in the audit communication process.

The Referent – Financial Statement Validity

The third element of the model is the referent, that "thing" to which the message in the text refers. In the case of audit reporting, the audit report is an opinion about the assertions made by management in the financial statements; that the "truth and fairness" of those statements. It is attesting to the validity of the financial statements: the degree of correspondence between the numbers in the statements and the actual financial position and performance of the company. The process by which the auditor arrives at a judgment about the validity of the financial statements is a complex one. There is not a straightforward relationship between "economic reality" and the financial statements.

The financial reporting system of a corporation records, in the abstract form of numbers, the economic events and transactions to which the corporation is subject over time, and *re*-presents them in the "representational text" that this is the financial reports for each financial period. Lee (1993:138) states that "the task of the corporate accountant is to create and present abstract accounting messages of former economic exchanges on behalf of management. He or she therefore brings the corporate past into the present by representing it in a set of financial statements. In doing so, shareholders and other external constituents of the reporting entity are given limited access to and vision of past events and related empirical phenomena. The main objective of this representation of the company's past is to facilitate future economic action by these individuals and organizations interested in but separated from the corporate structure".

There is a degree of choice or flexibility available to corporate accountants and managements in what and how things are selected to be measured and disclosed in the financial statements; for example, in such controversial areas as off-balance sheet

financing, accounting for groups of companies, accounting for goodwill, brands and other intangibles, and for capital issues and financial instruments, but also more generally in the timing of revenue and expenses and the recognition and valuation of assets and liabilities. Hopwood (1990) suggests that making visible parts of the economic past implies the presence of a selection process used by reporting management and accountants, in which other parts remain invisible; quantified but subjectively based accounting calculations provide an apparent precise realism to economic phenomena which would otherwise be imprecise and unreal; and economic actions, which otherwise might not be, are enabled to take place by the visibility created by the calculations. The task of the corporate auditor therefore involves verifying that the process of judgment and selection has produced a set of financial statements which truly and fairly represent the actual economic activities and position of the corporation. The auditor achieves this by observing (as far as is practicable) the physical reality; verifying (by obtaining audit evidence, constrained by cost-benefit considerations) the accounting process of abstracting reality; and finally making a judgment as to the quality of the representation of the abstractions in the financial statements.

Schandl (1978:2) states that "the auditor has to arrive at an opinion (judgment) on the truth of the purported evidence. In this phase of the audit he is using the norm system of 'reality' for his judgment". The view that auditors are attempting to establish the degree of correspondence between the statements and economic reality is one commonly expressed (see, for example, Schandl, 1978; Sterling, 1979; Wolnizer, 1987 and Ruud, 1989). The concept of "economic reality" is not, however, unproblematic.

It has been argued (for example, Hines, 1988; Morgan, 1988) that the financial statements themselves create economic reality. As public representations of the corporate past they become part of a complex mix of present and future economic, political and social realities. Thus, when accountants attempt to communicate aspects of reality to financial statement users, they also create the further reality of the statements themselves, which when used in decision making further reshape reality (Lee, 1993).

The prescriptions of accounting regulatory bodies also require accounting to represent and correspond with the underlying economic reality. In Australia, Statement of Accounting Standards SAC 3, *The Qualitative Characteristics of Financial Information*, prescribes "relevance" and "reliability" as the two primary characteristics that financial information should possess:

> "For financial information to be <u>relevant</u> it must have value in terms of assisting users in making and evaluating decisions about the allocation of scarce resources and in assessing the rendering of accountability by preparers … it must assist them in making predictions about future situations and in forming expectations, and/or it must play a confirmatory role in respect of their past evaluations [para.8]
>
> The <u>reliability</u> of financial information will be determined by the degree of correspondence between what that information conveys to users and the underlying transactions and events that have occurred and been measured and displayed. Reliable information will, without bias or undue error, faithfully represent those transactions and events [para.16]"

The criterion of "representational faithfulness" is obviously concerned with the correspondence of the reported information to economic reality. How does the auditor go about determining the reliability of reported information? The process includes assessing the efficacy of the internal control systems in place, and assessing compliance with legislative requirements, accounting standards and generally accepted accounting principles (GAAP).

It is not a simple task for the corporate auditor to verify the reliability of reported financial information. This is due in part to the nature of economic phenomena which are required to be audited. Sterling (1979:213) sees the primary problem of accounting being that the figures do not have empirical referents:

> "The fault lies neither in the abstract nor in the concrete but in ourselves – we do not know how to adjust our accounts. It figures do not represent empirical phenomena, then it is the preparers and purveyors of the figures who are at fault, not the phenomena. The solution to the problem is to adopt the objective of reporting figures that represent empirical phenomena. The first, and foremost, generally accepted accounting principle should be that we account for empirical phenomena. The kind of phenomena that we decide to account for is important, but secondary …The first and foremost objective of auditing should be the assurance that the figures accurately represent the empirical phenomena that they are intended to represent."

Ingram and Rayburn (1989) also argue that accounting cannot map reality because of a lack of empirical referents. Some economic phenomena, however, do have an empirically observable and testable physical reality; for example, the sale or purchase of goods and services. Others do not. Mattessich (1991) distinguishes categories of economic phenomena. Specific transactions, such as sales or purchases, have the effect of also changing less tangible aspects of corporate reality (for example, liabilities, equity and income). Some phenomena are therefore tangible and have a physical nature (for example, inventory and other assets); some are intangible and constructed from social relationships (typically, legally contracted and representing debt and credit, or representing intangible future benefits); and others are social constructs derived from a prior recognition of the above physical and social realities (such as periodic income) (Lee, 1993:157).

In sum, the accounting process which the auditor is required to assess is one which is based on selective recording and measurement of economic phenomena which have varying degrees of empirical observability. The preceding discussion highlights that

for the auditor, the process of arriving at a judgment about the validity of the financial statements is a highly complex one, where there is nothing absolute about the outcome.

Users of financial statements also arrive at some judgment about the validity of financial statements. Unlike the auditors, they do not have access to the detailed accounting records of the previous period's economic transactions and events, but only to the summary statements presented in the annual report. Users also have access to other sources of information, such as media reports and advice from financial analysts, from which to arrive at their judgment of financial statement viability.

In the "real world" then, the judgment of the validity of financial statements is a complex one for both auditors and users, and necessarily subject to wide variation.

Summary and Conclusion

This paper presents an analysis of the audit report communication function, utilising a semiotic model of communication derived from literary theory to analyse the audit report as a written text. It is argued that the type of linear, one-way process models which have been implicitly applied in much of the existing literature, are overly simplistic, and do not capture the richness and complexity of the process of communicating financial statement information.

The three elements of the model are the individual (auditor or user), the text (the audit report) and the referent (that to which the text refers, which is financial statement validity). The meaning of an audit report in any instance is a function of the interaction of all of these elements, all of which are variable, which takes within a particular context, subject to a particular set of economic incentives, at a particular time. The meaning of

audit reports, for different parties, is thus not an absolute or somehow intrinsic in the wording of the audit report, but is always going to remain to some extent contested.

To focus, therefore, on addressing the AEG by "education of the public" and tinkering with the wording of audit reports, does not represent a "solution" to the problem. Expectation or communication gaps will always be present in the audit report communication process, as the meanings of audit reports, being contextually bound, are subject to inevitable variation.

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FIGURE 1

Shannon and Weaver's Process Model of Communication Applied to Audit Reporting
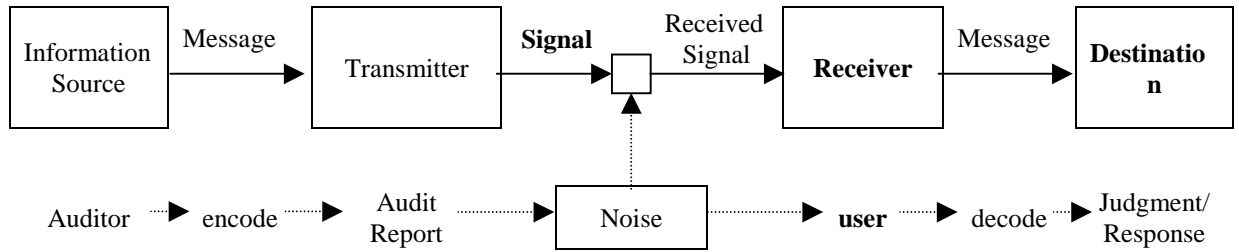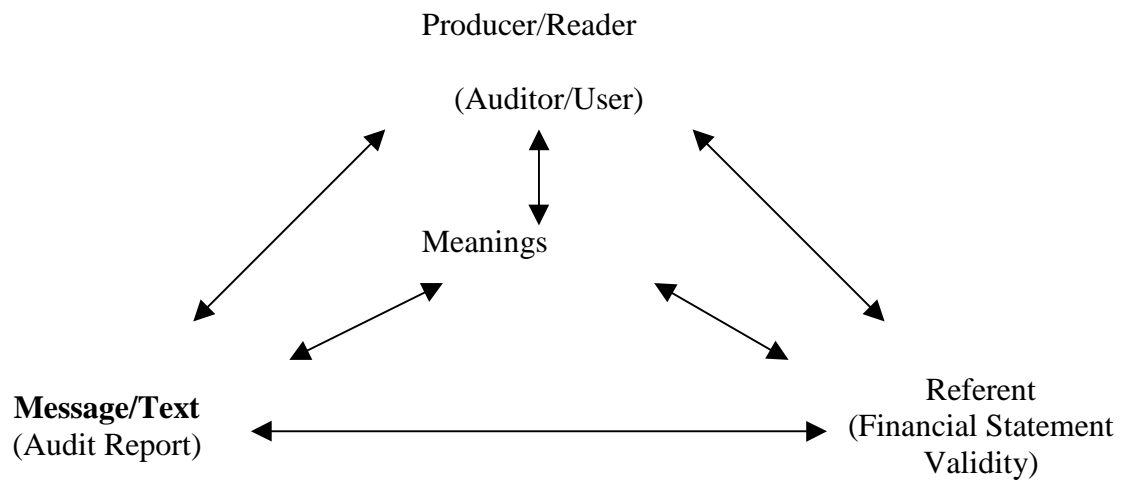(Source: after Shannon & Weaver, 1949)

| Information Source | →Message→ | Transmitter | →**Signal**→ | □ | →Received Signal→ | **Receiver** | →Message→ | **Destinatio n** |

| Auditor | ⇢ | encode | ⇢ | Audit Report | ⇢ | Noise | ⇢ | **user** | ⇢ | decode | ⇢ | Judgment/ Response |

FIGURE 2

General Semiotic Model of Communication Applied to Audit Reporting
(Source: after Fiske, 1990)

Producer/Reader

(Auditor/User)

Meanings

Message/Text
(Audit Report)

Referent
(Financial Statement
Validity)

This paper takes a different approach: it seeks to develop a theoretical model to explain the communication process of audit reporting, and from this, reasons why the gap would exist. Initially, it is established that auditing is a communication process. A semiotic model of communicative activity, developed in literary theory to analyse written texts, is applied to the audit report. Checking up CPA auditors are people who give your company its annual â€œphysical exam.â€ This audit exam uncovers issues that your company may not have known. Therefore, having an audit keeps the company on its toes. Reporting After the completion of the audit examination, the CPA creates an audit report sample. This includes a statement on whether the company prepared its financial report correctly. The requirements for audit depends on whether you have a public or private business: Public: These include businesses who have debt securities and ownership traded in the US public markets. Saussure also envisaged semiology (semiotics) as a science of signs in general, not only linguistic signs (words). Language is only one of the systems that is studied by semiotics. Semiotics was viewed by Saussure as a key to unlocking a variety of cultural phenomena all of which are various sign systems. Semiotics of Roland Barthes and his theory of myth. Roland Barthes helped found the modern science of semiology, applying structuralist (or semiotic) methods to the â€œmythsâ€ that he saw all around him: media, fashion, art, photography, architecture, literature.Â communication: such as representations, photography, cinema, reporting, sport, shows, publicity (cf. footnote on p. 112). p. 111 So a photograph is â€œa kind of speech,â€ in the same way as a newspaper article.