Comment letter* prepared in response to the IIASB Invitation to comment: Improving the Auditor's Report

Jean Bédard
Université Laval

Paul Coram
University of Melbourne

Reza Espahbodi
Washburn University

Theodore J. Mock
University of California, Riverside

October 8, 2012

*Note: This comment letter is based on a synthesis of the literature on the audit reporting model (Mock et al. 2013) which is attached to our comments and is written by a subset of the synthesis authors. This comment letter, however, expresses the views of the authors and does not reflect an official position of the American Accounting Association, the Auditing Section of the AAA or any other organization.

Introduction

The IAASB has invited comments concerning the disclosure of additional information highlighting matters important to users' understanding of audited financial statements or the audit. In this comment letter, we offer our evaluation on whether the considered disclosures, individually or collectively, are likely to enhance the relevance and informational value of the auditor's report. Our evaluation is based on the findings of prior research on whether (1) the considered disclosure involves information that a variety of potential users perceive to be useful, and (2) how users use and react to that information. That is, we focus on research that relates to the demand for, understanding of, and use of auditor communications. This includes research that provides evidence on possible effects of auditor communications on investors and other users, and research indicating audit terminology that may need to be clarified.

This is the semiotic view of communication theory, as opposed to process theory. The process theory does not take into account contextual factors, which may result in differing interpretations of the same information. Process theory views communication as the transmission of messages, wherein information is enhanced when the system carries the maximum amount of information.

On the other hand, the semiotic view of communication adds the human element to the framework, and examines the relationship between source, receiver and text to determine the meaning of communication. This model of communication is triangular in that meaning is derived from the interrelationships between the producer/reader (auditor/user), message/text (the audit report), and referent (the financial statement) (Fiske 1990; Hronsky 1998). This type of evaluation of communication is complex and Schandl (1978) highlights that a major problem of communication is predicting the effect of data on the receiver in terms of the interpretation and inferences drawn.

The focus of many of the audit standard changes and academic studies has been primarily on examining the effect of wording changes in the audit report and how it has affected users' perceptions and decisions. ISA 700 is a prominent example. This standard is consistent with a process school view of communication, which suggests that provision of more information in the audit report should improve its communicative value.

Prior literature has criticized the approach of the auditing profession to deal with perceived limitations in the current audit report. This literature suggests that the profession has, until now, ignored the information gap and focused on trying to close the expectation gap, the gap between what users expect from the auditor and the financial statement audit and the 'reality' of what an audit is. And, even at that, the expanded audit report did not reduce even the expectation gap in some areas. Specifically, although the expanded audit report closed the gap on areas associated with the audit process and audit environment, it also moved users' perceptions further away from auditors on a number of dimensions related to the outputs of the audit.

The nature of the possible revisions to the audit report included in the IAASB Invitation to Comment suggests that, with one exception described below under Other Topics, the IAASB recognizes the limitations of the process school in closing the expectation gap. Further, it reflects the importance of closing the information gap, namely the differences between what users desire and what is available to them through the entity's audited financial statements and the audit report thereon or other publicly available information. That is, the IAASB is now focusing on the semiotic approach to communication theory. In our judgment, the IAASB's focus on closing the information gap is commendable.

The rest of this comment letter evaluates whether the audit report changes being considered, individually or collectively, may be expected to enhance the relevance and informational value of the auditor's report. We organize our comments around Suggested Improvements and Other Topics.

Again, our evaluation is based on the findings of prior research on whether (1) the disclosure involves information that a variety of potential users perceive to be useful, and (2) how they use and react to the information. By evaluating these broader contextual factors that affect the "meaning" attributed to audit reports, we provide a framework to assist in approaches to develop the audit report to reduce the expectation and information gap. This framework is elaborated further in the synthesis report (Mock et al. 2013).

Suggested Improvements

1. ***Additional information in the auditor's report to highlight matters that, in the auditor's judgment, are likely to be most important to users' understanding of the audited financial statements or the audit, referred to as "Auditor Commentary." This information would be required for public interest entities (PIEs) - which includes, at a minimum, listed entities - and could be provided at the discretion of the auditor for other entities. (Q3-Q7)***

Our research synthesis provides some direct and indirect evidence regarding the additional information in the auditor's report. First regarding the need, a few academic studies have identified stakeholders' desires for other information from the auditor. Overall, these studies confirm the information obtained by professional associations' findings (e.g., CFA Institute 2010; Audit Quality Forum 2007): users want information about the quality of financial statements, including more transparency and information on key risk areas (Mock et al. 2009). Because these results are based primarily on survey data, and stakeholders' focus groups, these studies do not provide any information on the associated costs and the extent of its use or usefulness.

While there is no direct evidence from academic research studies on the provision of additional information by auditors, a consultant study of auditor's justification of assessments in France suggests that users appreciate the flagging of areas of importance and take a closer look at the items referred to in the justification. However, merely describing audit procedures is not seen to be very useful to users.

Providing additional information in the auditor's report is consistent with and builds on the concepts of Emphasis of Matters and Other Matters paragraphs. Our research synthesis reviews recent research concerning the Emphasis of Matter paragraph on the entity's ability to continue as a going concern. Overall, the results suggest that the Emphasis of Matter paragraphs do not have information content to users once the underlying information is disclosed somewhere else (e.g., notes to the financial statements and MD&A). Recent findings in Menon and Williams (2010) indicate that a GC audit report is more informative when it provides "new" information, for example when it cites a specific problem with financing.

Overall, our research synthesis suggests that there is a need for additional information and that such information is valued by users because it directs their attention-directing value. Such communications are even more valued when they provide new information to the users.

The research synthesis does not provide information as to the costs such as audit report delay or additional audit fees associated with the disclosure of additional information and their impact on auditor, management, and audit committee behavior.

Summary of research:

Research indicates that there is value in this type of enhanced disclosure.

2. ***Auditor conclusion on the appropriateness of management's use of the going concern assumption in preparing the financial statements and an explicit statement as to whether material uncertainties in relation to going concern have been identified. (Q8-Q10)***

Church et al. (2008), synthesizing earlier research, find mixed results on the value of explicit auditor reporting concerning the going concern (GC) assumption. More recent research such as Herbohn et al. (2007) finds no short-term market reaction to the release of the annual report containing a GC modification. Taffler et al. (2004) find that the market underreacts to GC reports in the U.K. In contrast, Citron et al. (2008), examining stock price changes for non-financial companies receiving a GC modification, find significant adverse price reactions in the period surrounding the announcement. Finally, Ogneva and Subramanyam (2007) examine 12- month returns following disclosure of first-time GC opinions in the US and Australia. They find no evidence of significant negative abnormal returns associated with GC opinions in Australia. In the US, negative abnormal returns subsequent to GC opinions are sensitive to choice of expected returns. However, using a substantially larger sample than previous studies (1,194 firms in the period 1995 to 2006), Menon and Williams (2010) observe negative excess returns when a GC audit report is disclosed. They find that the reaction is more negative if the report cites a problem with obtaining financing, suggesting that GC reports provide new information to investors.

Thus, in general, there is no convincing evidence as to whether having auditors communicating information on going concern improves the value of current auditor communications. However, recent findings in Menon and Williams (2010) indicate that a GC audit report is value relevant (informative), and the informativeness of the report increases when the report provides “new” information. The considered requirement that an explicit statement as to whether material uncertainties in relation to going concern have been identified does potentially provide new information and thus should improve the relevance and informational value of the auditor’s report.

A further comment on this issue is that most of this archival research relates to a going concern problem being reported. The changes being considered by the IAASB to require an explicit statement in the auditor’s report about the efforts conducted by the auditor on the issue of going concern will in the vast majority of cases not highlight any problems. However, an expectation of users that the auditor comments on the future of the company is something that has been a part of the audit expectations gap over many years (e.g., Monroe and Woodliff 1994). Therefore, it is reasonable to expect that changes in this area would be well received by users of financial statements.

<u>Summary of research:</u>

- There is no convincing evidence on the value of disclosure by the auditor of a company’s going concern problems once the underlying information is disclosed.
- Also, research on the expectations gap suggests users want to know about the work auditors have done on evaluating a company’s future prospects.

3. Auditor statement as to whether any material inconsistencies between the audited financial statements and other information have been identified based on the auditor's reading of other information, and specific identification of the information considered by the auditor.

Prior research demonstrates that MD&A (or management commentaries) is an important component of financial reports (Rogers and Grant 1997; Tavcar 1998), that it provides incremental information to the markets beyond earnings (Bryan 1997; Clarkson et al. 1999; Francis et al. 2003; Brown and Tucker 2011), and that it is useful in predicting future economic outcomes (Bryan 1997; Jones and Cole 2005).

Recently, academics and regulators have raised questions as to whether MD&A

presentations and other information outside the financial statements should be audited by the external auditor, the subset of information that should be audited, the level of responsibility that auditors should take, and the extent to which the audit report should explain these responsibilities. This suggested improvement reflects some aspects of this debate.

In recent stakeholder discussions facilitated by the Center for Audit Quality (2011), participants identified financial information contained in MD&A and risk factors disclosed in the annual report as areas that could be improved by management and/or might be appropriate for auditor association. In a similar study, Fraser et al. (2010) conduct two surveys and 26 semi-structured interviews to determine whether or not there is a demand by investors and other stakeholders for external assurance on management commentary and on other similar reports. They find that stakeholders generally find management commentary useful, but that they differ in the importance they attribute to it. Also, both investors and non-investors desire at least some external assurance on management commentary to identify inconsistencies with audited information, to curb excessively optimistic directors' statements, and to provide more transparent disclosure.

Overall, although sparse, interview studies suggest that users find the information currently included in MD&A and similar documents useful. This usefulness is corroborated by archival studies, which find that the market reacts to the information disclosed in the MD&A. Research also provides some support for the provision of assurance on MD&A presentations and other information outside financial statements, at least on the verifiable components such as financial information and key resources and risks, based on the perceptions that the assurance lends credibility to the completeness and accuracy of such information and reduces management's bias.

However, no study has examined the effect of the auditor's association with the MD&A, reading it and assessing whether it is consistent with the information in the audited financial statements and his/her knowledge, or improve the quality of the MD&A. Although results from studies on auditors' assurance on other information, both financial (management forecasts and quarterly financial statements) and non-financial (internal control) indicate that auditors' assurance may improve the quality of the MD&A information, there is no direct evidence on whether such assurance improves the quality of the MD&A. Whether an auditor's review or audit report on MD&A will be useful is an empirical question that is yet to be resolved.

Additionally, as Blay (2005)[1] points out, changes in the regulatory environment that

[1] Blay (2005) experimentally investigates whether economic incentives associated with different levels of auditor independence threats (fear of losing the client) and litigation risk influence auditors' evaluation of information and their subsequent reporting choices. He finds that threats to independence lead auditors to evaluate information in support of a client-preferred conclusion and that high litigation risk results in the opposite tendency. Furthermore, auditors facing high levels of both independence threats and

affect independence threats and litigation risk could change both the auditors' evaluation of evidence and the quantity of evidence they examine. Thus, the IAASB and other regulators should be mindful of the impact of auditor's association with MD&A and other information on evidence collection and evaluation.

Summary of research:

- Limited research evidence suggests that stakeholders generally value management commentary, and they desire at least some external assurance on it. However, the value of auditor commentary on the quality of the information in management commentary is uncertain.

4. Prominent placement of the auditor's opinion and other entity-specific information in the auditor's report. (Q13)

Our research synthesis does not provide much evidence on the "ordering" of information in the auditor's report. While our research synthesis was not specifically addressing this topic, it does not seem that there has been much research on this issue. The only study from our synthesis that addressed this question was by Chong and Pflugrath (2008). In an experiment they found reordering of the audit report to place the audit opinion at the front appears to have some value in reducing the expectations gap.

The IAASB's reasoning to put the audit opinion at the front of the auditor's report is based, at least in part, on the assertion that the "pass/fail" nature of the auditor's opinion has value (p.17). Our research synthesis suggests that being a "pass/fail" signal is the way the auditor's report is perceived by many users. We find that in its current iteration the auditor's report does have value and this is primarily related to establishing whether it is unqualified or not (i.e., pass or fail) (Asare and Wright 2009; CAQ 2011; Gray et al. 2011). Even with all of the other potential changes being considered by the IAASB to the auditor's report, it seems likely that for a number of users, this pass or fail will still be the main point to be ascertained from the auditor's report. Therefore, it is our view that it makes sense to highlight the opinion at the beginning of the auditor's report. Highlighting the opinion to these users will also become particularly important if changes are implemented to add extra information to the auditor's report – as the opinion could become more "lost" in the new auditor's report.

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litigation risk searched for and evaluated more information than auditors facing any other combination of these risks.

<u>Summary of research:</u>

- Limited evidence suggests re-ordering of the auditor's report to put the audit opinion at the beginning would have value to users.

5. Further suggestions to provide clarity and transparency about audits performed in accordance with ISAs. (Q2)

We describe possible extra information in the auditor's report identified from our research synthesis as fitting into one of two broad categories:

- About the entity being audited
- About the audit that was conducted

In the 'Invitation to Comment' there are quite a few details about suggested improvements that cover many of the issues we highlighted as important to improve clarity and transparency about audits from our research synthesis.

Most of the tangible suggestions being considered by the IAASB seem to be *about the entity being audited*, with significant possible changes to enhancements in an "audit commentary" section (pp.21-28) and "going concern" section (pp.18-20). We commented on our research synthesis findings relating to these topics earlier in this feedback document.

Another area about the entity being audited that we found to be important from our research synthesis related to auditor responsibilities in evaluating <u>internal controls over financial reporting</u>. There do not appear to be significant changes to the auditor's report being considered by the IAASB on this issue. There is quite a bit of research on audit opinions on internal control because they have been mandated under Sarbanes-Oxley in the US. Our research synthesis reports evidence of the benefits of assurance of this type of disclosure from both behavioral studies (Schneider and Church 2008; Shelton and Whittington 2008) and archival studies (Doyle et al. 2007; Ashbaugh-Skaife et al. 2008/2009; DeFranco et al. 2005; Cheng et al. 2006; Rezaee et al. 2012).

Where there are less tangible changes being considered by the IAASB in the 'Invitation to Comment' on a new auditor's report, they relate to provision of more information about the *audit that was conducted*. Our research synthesis found users perceive more disclosure on the <u>materiality</u> levels used in the audit that was conducted to be important (Gray et al. 2011; Houghton et al. 2011; Coram et al. 2011; CFA Institute 2010). This was consistent with the literature review conducted by Church et al. (2008). Another area perceived as important relates to more information on <u>key risk areas</u> identified as part of the audit process (Mock et al. 2009; CAQ 2011).

A limitation of research that evaluates users' perceptions on what they want from an audit report is that it is limited to behavioral type studies, because it evaluates disclosures that do not exist in practice. Similarly, evidence on the use of this type of information is limited for the same reason. Despite the above limitations, the evidence that is available and has been cited from our research synthesis consistently suggests that more information about the audit that was conducted would be valued by users of financial statements. This should be relevant and important to regulators and standard setters as it represents the research reflecting the responses of more than 1,400 participants.

The potential cost of these additional disclosures is also an issue that is difficult to address in evaluating disclosures that do not exist in practice. There is limited information available on what these additional disclosures might cost. Further, it is unclear whether users' perceptions on this expanded audit disclosure would vary if they became aware of the costs associated with it. Mock et al. (2009) note that much of this type of disclosure about the audit that was conducted is already reported to management. We relate this to the cost issue in our synthesis by making the following point, "...for disclosures on information that the auditors already examined or collected under existing professional guidance, it cannot be assumed that public disclosure will increase audit costs or fees substantially."

Summary of research:

- Research suggests that there would be value in disclosing the auditor's opinion on the quality of the company's internal controls over financial reporting.
- Research also suggests that users are interested in information on the materiality levels used in the audit and also key risk areas identified by the auditor in conducting the audit.

Other Topics

1. Enhanced description of the responsibilities of management, those charged with governance, and the auditor

Prior experimental research (e.g., Kelley and Mohrweis 1989; Miller et al. 1993; Gay and Schelluch 1993; Monroe and Woodliff 1994; Inneset al. 1997; Gay et al. 1998) suggests that the wording changes in the auditor's report implemented in the late 1980s via SAS 58 to better explain the auditor's and management's responsibilities were noticed by investors. However, the changes do not seem to improve the communicative value of the audit report in other dimensions, particularly in the areas that comprise the audit expectation gap. In fact, the evidence suggests that these changes exacerbate the expectation gap in certain areas. Specifically, participants perceive the auditors as having less responsibility than previously, and the expanded audit report did not affect their perceptions about the auditor's likelihood of detecting fraud.

Research on the recent changes under ISA 700 (Baskerville et al. 2010; Gold et al. 2012; Coram et al. 2011), which further expanded the description of auditor's responsibilities suggests that these changes have been even more unsuccessful than the changes which created the SAS 58 audit report. This finding is consistent across a number of different countries and through the use of various research methods. A conclusion that could be drawn from all of this research is that if the audit report is to improve in its communicative value to reduce the expectation gap, then a different approach is probably warranted to the traditional method of changing the wording in the attempt to better explain responsibilities and basic features of the audit process.

To sum, survey, experimental and protocol studies all suggest that an enhanced description of the responsibilities of management, those charged with governance, and the auditor is unlikely to be helpful in reducing the expectation or the information gap. In fact, such an expanded report might take users' focus away from other information contained in the auditor's report. However, in our judgment, description of responsibilities of various parties as they relate directly to the current audit (e.g., the actual level of assurance achieved in the audit) would enhance the relevance and informational value of the auditor report. The IAASB's objective of enhancing the description of the responsibilities can be achieved by placing the standardized material describing the management's and auditor's responsibilities on a website of the appropriate authority.

Summary of research:

- Research suggests that further disclosure of this type of information is unlikely to be of value.

2. Disclosing the name of the engagement partner (Q12)

A primary argument for requiring lead and concurring partners' signatures on the audit report is the improvement in audit quality due to the assumption of increased responsibility and accountability on the individual audit partners and improved transparency of the audit process.[2] But, identifying an individual partner on an audit report could potentially mislead users about the degree of the responsibility of the individual partner. The audit opinion on an audit is the collective responsibility of the

[2] Reputation effect is a likely economic reason for an increase in audit quality. However, since the engagement partner's name is generally publicly disclosed in the event of an audit failure, reputation effect is the same whether or not the partners sign the audit report in their own names.

firm and the opinion is normally the result of consultation with a range of partners and sometimes outside specialists. Possible ways to take care of the potential legal and practical issues and the need for greater accountability and transparency are: (1) to have the lead engagement and concurring partners sign the report on behalf of the firm; and (2) to disclose the name of the engagement partner along with the names of any outside firms or other specialists who contributed to the audit but not require the engagement partner's signature.

There is no direct evidence as to the effect of the signature on user decisions or judgments. And, unfortunately, the few recent studies that examine the relation between auditor signing and audit quality based on archival and experimental evidence provide mixed results. On the one hand, Chi and Chin (2011) find that the clients of lead signing auditor specialists, alone or in conjunction with concurring auditor specialists, have smaller accruals and are more likely to receive a modified audit opinion compared to those audited by non-specialists. Chi and Chin’s results suggest that audit partners’ signature are value relevant, that is they are useful in assessing the quality of the audit and of financial reports.

Contrary to Chi and Chin (2011), Blay et al. (2012a) find no evidence of increased audit quality for their sample of Dutch and U.K. firm-year observations as a result of requiring a partner-level signature in the Netherlands relative to both prior years and a control sample of UK firms, where legal liability associated with the partner’s signature did not change until later. They argue that the implementation of a partner-level signature, without increased litigation risk, may not have the desired effect of increased audit quality.

Carcello and Li (2012) find that the U.K. signature requirement imposed in 2006 has led to better audit quality, but also higher audit fees. Specifically, in the first year after the introduction of the signature requirement, there is a significant decline in abnormal accruals and the propensity to meet an earnings threshold, and a significant increase in the incidence of qualified audit reports and in earnings informativeness. In addition, audit fees are significantly higher in the post-signature period than in the pre-signature period. The study fails to demonstrate a cause-and-effect relationship between the signature requirement and increased audit fees.

The two experimental studies on auditor signature issue also offer mixed results. Schatzberg et al. (2005) find that auditor misreporting that is explicitly costly to investors is more likely with higher than with lower moral reasoning participants. On the other hand, Blay et al. (2012b) find that auditor misreporting is lower when the auditor is required to sign-off on the audit report when the investor is another participant. They also find that auditor misreporting is negatively associated with the auditor’s score on two measures of moral reasoning. Their results provide strong evidence that moral reasoning (helped by an auditor signature) can reduce auditor misreporting.

Besides the mixed findings, a recent commentary by Davis, King and Mintchik (2012) purports that while prior evidence implies that mandatory signature will likely increase audit effort and thus “audit quality in appearance,” its impact on actual audit quality remains unclear and controversial. They further argue that “the increase in public perception of audit quality without an associated increase in actual quality is a desirable accomplishment only when the public perception is below actual audit quality. Otherwise, the measure increases the gap between delivered audit quality and public perceptions of it (p. 1).”

Although the archival and experimental studies discussed above provide mixed results, and Davis et al. (2012) question the increase in audit effectiveness, the weight of evidence and the more recent evidence suggest value to individual audit partners’ signature. Further, a mandatory partner-level signature requirement may yield other potential benefits, for example, a signature requirement may increase investor confidence in financial reporting. Finally, indirectly related to the auditor signature requirements, quite a few other studies (Davidson and Stevens 2010; Chang et al. 2006; Lobo and Zhao 2006) document more conservative financial reporting, and positive stock price movements as a result of management certifications of the company code of ethics and financial statements. Extending the conclusions of the above certification-related studies to auditor reporting, it is conceivable that partner-level signature increases investors’ confidence in corporate disclosures and thus has a positive effect on the market value of certifying firms.

Summary of research:

- Research evidence is mixed, but the disclosure of the name of the engagement partner is likely to increase the value relevance of the audit report.

Overall Comment

Overall, based on the findings of relevant research, we believe that research indicates that many of the disclosures and changes being considered are likely to enhance the relevance and informational value of the auditor’s report. However, the research varies as to the strength of evidence and to the degree that the evidence is mixed. In addition, the extant research usually provides little, if any, evidence of expected costs associated with changes being considered.

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