The Unqualified Auditor's Report: A Study of User Perceptions, Effects on User Decisions and Decision Processes, and Directions for Further Research

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This report provides a synopsis of a project requested and sponsored by the Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB). The project has two primary objectives with the first being to identify and provide insight on the nature and underlying causes of user perceptions regarding the unqualified auditor's report among various classes of financial statement and auditor's report users. This objective is achieved in part one of this study. The second objective is to examine if and how an unqualified auditor's report impacts the judgments of financial statement users. This objective is achieved in part two of this study. Based on our findings, we offer directions for future research on issues that could improve the usefulness of the unqualified auditor's report and the overall transparency of the financial reporting process. Full details both of our findings and of directions for future research will be included in a forthcoming final report.

1. Research Design

Our research examines two sets of the possible forms of unqualified auditor's reports. The first, used in the focus group segment of the study, consists of the U.S. form of report prescribed in Statement on Auditing Standards (SAS) No. 58—*Reports on Audited Financial Statements*, issued by the ASB in 1988 (AICPA 1988). For this form of report, we evaluate both the unqualified three-paragraph report and one variation, an unqualified three-paragraph report with an additional paragraph related to going-concern issues. The second set, used in the verbal protocol segment of the study, consists of a short form of report similar to that detailed in SAS No. 58 modified slightly for an Australian audience, and the international form of unqualified report prescribed in ISA 700 (Revised), *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*, issued by the IAASB in 2005 (IAASB 2005). These forms were used for this segment of the study as all participants were Australian analysts and were familiar with both forms of report.

1.1 Focus Groups

To elicit information from the various stakeholders, a series of focus groups were conducted between May and October, 2008. Focus groups were used to provide a setting where participants felt comfortable expressing their attitudes, opinions, and experiences regarding the unqualified auditor's report and the environment surrounding that report and to provide suggestions on how to improve the auditor's report. Each focus group was moderated by a research team member experienced in focus group methodology and each session lasted approximately two hours. Questions were asked in an interactive group setting where participants were free to react to other group member comments and participants were told their comments would be used without attribution.

Five different categories of stakeholders were invited to participate, including: (1) preparers of financial statements that are subsequently audited (the CFOs),[1] (2) bank lenders who review audited financial statements in support of loan applications and for continuing support of ongoing loans, (3) financial analysts who review audited financial statements from an investment perspective, (4) non-professional investors, and (5) auditors who audit financial statements in compliance with AICPA audit standards.[2] A total of 53 individuals participated in the focus groups.

Each category of stakeholders met separately, but with the common objectives of (1) identifying the nature of perceptions regarding an unqualified auditor's report, and (2) determining the user's knowledge and perceptions about a financial audit conducted under generally accepted auditing standards.[3]

A key point about focus groups is that they are a form of *qualitative* research. Because focus group participants are few in number and are volunteers versus randomly selected members of a population, no attempt is made to quantify the results. Terms such as *generally* or *most* are used to indicate that the majority of participants seemed to agree on some point, but no actual counting of votes or similar actions were taken. Only through follow-on, more quantitative research can the strength or weights associated with various attitudes and opinions be quantified.

1.2 Verbal Protocol Analysis (VPA)

While a financial statement user may have some perception about the level of assurance indicated by an unqualified auditor's report, actual decisions may be based on completely different factors. To examine if and how the unqualified auditor's report impacts the judgments of financial statement users, a different methodology was used—that of verbal protocol analysis (VPA). VPA differs from focus groups in that instead of a group of participants, each VPA participant works individually on a task provided by the researchers and is a research method

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[1] For simplicity, we refer to members of this group as "CFOs". Not every participant currently held the CFO title, but all either were senior-level financial executives in their organizations or have been in the past but now were retired or were now providing consulting services to that group.

[2] The CFO focus groups were volunteers from the Los Angeles and New York chapters of the Financial Executives International (FEI) and the analyst focus group consisted of volunteers from the New York chapter of the CFA Institute. The other groups requested anonymity, but the auditors consisted of managers and partners from two large, international accounting firms, with one focus group held in Los Angeles and a second held in New York City. Bankers were from a single international bank and the non-professional investors were members of a private investment club.

[3] Much of the focus group discussions covered issues that relate to both private and public companies. While the focus groups were conducted in the U.S., much of what surfaced in these discussions may generalize to IAASB-based audits as well as ASB-based audits.

where participants are asked to ‘think aloud’ while performing a task. These verbalizations are taped and transcribed to be used as evidence about the decision-making and information evaluation process.

In this study, participants were asked to estimate the per share price of a company based on a set of provided financial statements and corresponding auditor’s report. All VPA sessions were conducted in Australia using a short form report similar to that in SAS No. 58 modified slightly for an Australian audience, and a longer form ISA 700 auditor’s report. A total of 16 individuals participated and all were experienced and currently-active financial analysts. As with focus groups, each VPA session was conducted by a research team member experienced in VPA methodology and each session lasted approximately one hour.

2. Results

As noted previously, this research has two major objectives. The first is to identify and provide insight on the nature and underlying causes of user perceptions regarding the financial statement audit and the unqualified auditor’s report among various classes of financial statement and auditor’s report users. The second is to examine if and how an unqualified auditor’s report impacts the judgments of financial statement users. Results from the two segments of the research are as follows.

2.1 Focus Groups

Each focus group session consisted of three parts with an overall goal of identifying the perceived information quality of the auditor’s report. Preliminary areas of discussion were identified as:

- The auditor’s report and participant perceptions of its intent with a goal of identifying misperceptions about the auditor’s responsibility and level of assurance provided;

- Audit procedures and financial statement content with a goal of identifying misperceptions about the audit process;

- Other issues that might be inferred from the auditor’s report.

Based on the focus group outcomes, the following issues were considered to be important to understanding the perceived information quality and content of an unqualified auditor’s report.

2.1.1 Level of Assurance. One issue raised in the Request for Proposals was: “….some users may not understand the level of assurance intended to be conveyed by the auditor’s report.” Across focus groups, the level of assurance generally was thought to be closely related to the concept of materiality. In fact, many in the auditor focus group felt the level of assurance and materiality essentially are the same thing. Over all focus groups, the issue of materiality generated the most discussion and revealed that materiality is considered to be a critical issue to many users.

Financial statement user groups indicated a very diverse understanding of the concept of materiality although they all did seem to understand that auditors do not audit accounts and transactions to a penny. However, users' guesses as to what the intended level of assurance or materiality actually are, especially for their own company (CFOs) or companies they were analyzing (bankers and analysts), varied from user group to user group. As one CFO said, "materiality levels are more secret than the Coca Cola formula." However, CFOs seemed to have the best understanding of materiality because most had prior Big 8 audit experience and had experienced audits both as an auditor and as a client.[4]

Participants provided a wide range of responses when asked, "If we agree a set of financial statements are not absolutely accurate, then how accurate are they?" One auditor said it would be impossible to have a specific value because of all the factors that go into calculating those numbers. Another auditor used the degree of restatement as a guideline, stating that at less than one percent would mean don't worry about it, at less than five percent, you are still okay, between five percent and ten percent, you are in a gray area, and over ten percent, you probably have some real problems.

One banker said it would be a very small number such as plus or minus two percent. Another banker said it may be plus or minus five percent while a third banker said the number could be higher depending on the type of loan. For example, if specific collateral was pledged for the loan, then the bank would tolerate a larger materiality level, maybe even plus or minus 10 percent to plus or minus 20 percent. Other bankers questioned whether such large potential variation would be tolerable even if collateral was pledged.

In general, analysts could not define a single percentage for net income. Instead, they said they would want to see plus and minus percentages for each line item, but then it becomes a problem trying to aggregate the impact of all those pluses and minuses. One analyst said he would prefer that the company just put all their notes about accounts with estimates in one place and explain the impact or sensitivity of those judgments. Another analyst said in addition to the company's disclosures of how they selected specific estimates and their judgments, analysts also would like a similar discussion from the auditor. For example, what did the auditor propose to the client as adjustments, why did they propose those adjustments, and if they were rejected by the client, why were they rejected?

Participants generally indicated the perceived level of assurance provided by Big 4 audit firms was higher than that provided by either second-tier or third-tier firms. There was a strong consensus among the CFOs that Big 4 firms definitely have more cachet and it does communicate something positive to the reader of financial statements if they are audited by a Big 4 firm. They generally agreed, however, the skills of auditors at second-tier firms in particular are as good as those at the Big 4. Bankers had similar perceptions that the quality of Big 4 audits may be higher than that of smaller CPA firms. One banker said that knowing the structure of

[4] Although we did not specifically ask participants if they had public accounting experience, based on comments during the focus groups, one banker was a CPA and two or three analysts were CPAs.

auditing firms, he presumes larger firms have a larger budget, more time, and adhere to different internal standards.

Among both the bankers and the analysts there was some debate about the benefits and concerns of having a big company audited by a relatively small auditing firm. On one hand, because the company is a major client of the firm, the company likely will receive more partner-level attention. However, there was concern that because of a smaller CPA firms' fear of losing a major client, smaller firms may be more flexible in acquiescing to the client's demands.

2.1.2 Sampling. All user group participants generally understood that auditors use sampling as part of the audit. However, as with materiality choice, sample sizes are not disclosed externally and user group perceptions surrounding sampling varied widely. Non-professional investors in particular thought sample sizes used are much larger than those most likely used by auditors. Some focus group participants thought sampling is more "scientific" than methods auditors actually use.

2.1.3 Internal Controls. The focus group participants generally indicated they do not assume an unqualified audit opinion indicates anything about the quality of the internal controls. However, bankers, CFOs, and analysts recommended that the quality of the internal controls be explicitly included in the auditor's report. The bankers indicated they sometimes will conduct their own internal control review of those parts of the company related to the specific aspects of the loan, such as controls over pledged inventory or pledged accounts receivables. This provides them with some additional comfort the pledged assets exist and are reasonably valued.

2.1.4 Internal Control Audits. CFOs seem to believe audits performed under PCAOB-based standards are superior to those performed under ASB-based standards. One CFO indicated an unqualified opinion on internal control increases his confidence in the financial statements. He said Section 404 activities have significantly increased the amount of time auditors put in at his company—sometimes it is two or three times as much as for a traditional financial audit. There is more documentation, more testing, procedures are more rigorous, and more people are involved with a PCAOB-based audit. One analyst thought the PCAOB-based audit is better because it explicitly includes an opinion about internal controls that provides some additional information about the company. Another analyst added the internal control information provides insights into general corporate governance.

Conversely, an analyst said when he asked his colleagues whether a PCAOB-based audit was better than an ASB-based audit, they said no, at least not in terms of their subsequent analysis of the financial statements. One auditor mentioned he believed the initial financial statement numbers presented to them by their clients are now more accurate under PCAOB-based audits because the client knows any adjustments may result in adverse opinions regarding the internal controls. That auditor concluded a PCAOB-based audit provides a better set of numbers.

It was noted that for private companies the audit primarily is for the owner and their bankers or other finance providers who understand the scope and risk associated with the audit. For public companies, users of financial statements are a much wider audience. One auditor said private companies typically have weaker internal controls, particularly in the area of segregation of duties. As such, internal control audits for private companies would always have some negative aspects to them. In general, concern was expressed that most internal control reports would be negative for private companies and it was not clear the value of negative reports to financial statement users.

2.1.5 Fraud. If the auditor's report does not specifically mention fraud, the participants assumed the auditors looked for fraud and none was found. In addition, some auditors expressed a concern that some users likely believe the level of assurance or materiality level applied to the overall audit also applies to fraud testing or detection, which is not necessarily true.

2.1.6 Going Concern. In general, there was a consensus among the various focus group participants that a going concern opinion is beneficial to users of the financial statements. User groups assumed that if additional language related to going concern is not included in the auditor's report, a going concern analysis was performed and the auditor concluded it was not an issue. There were differences in perception, however, between the auditor group and the user groups as to the degree of analysis performed. Auditors stressed their going concern analyses consist of forecasting cash flows and other key financial data for one year to determine if the company likely will have sufficient liquidity to operate through that year and that they do not evaluate management, the company's business model, the quality or competitiveness of products, etc. In other words, auditors do not perform an analysis that might be performed by a Wall Street financial analyst to determine if a company is a good investment.

There also was discussion of what might be implied by the absence of a going concern unqualified auditor's report For example, one CFO said he thought people believe not having the going concern statement means the company is financially healthy and they have sound business practices. Another CFO said there is an implication a company is financially healthy by the virtue of the lack of a going concern statement and that is a reasonable expectation of the reader of the report. However, a third CFO said he did not agree with that assumption as there is a difference between being financially healthy, meaning the company is not going out of business, and being a good value, meaning they are a well-run, successful business.

2.1.7 Overall Usefulness of Unqualified Auditor's Report. Based on the focus groups, financial statement users do not appear to actually read the entire auditor's report and, in fact, non-professional investors indicated they do not even look at the report. CFOs, bankers, and analyst groups indicate they look at the auditor's report only to see if there is an unqualified opinion and which audit firm signed the report.

If the report is unqualified and signed by a Big 4 firm, then they do not consider it again. If it is not signed by a Big 4 firm, they may try to determine the qualifications or reputation of the audit firm. At least one participant in each focus group, including the auditor group, commented that a simple "OK" could replace the existing unqualified auditor's report. An auditor taking this comment a step further said that in addition to "OK", the name of the auditing firm and the standards under which the audit was conducted also should be included.

Participants in all focus groups except the non-professional investors frequently stressed the point that the audit and auditor's report essentially are a compliance issue in that an audit is required. For public companies, it is required by the SEC, and for private companies, it typically is required by the bank, venture capitalist, or other organization providing financing to the company. The auditor's report indicates the organization either passed or failed the audit. Several participants echoed the binary aspect of the auditor's report using terms, such as pass/fail and "check the box," which means to see if an unqualified opinion is there and if yes, move on to analyzing the financial statements.

It is important to note that these comments regarding the current auditor's report should not be interpreted that users do not value the audit or the auditor's report. Quite the contrary was true. All participants in the user groups, including the non-professional investors who indicated they never look at the auditor's report, value both the audit and the auditor's report. Participants were unable to place a quantitative value on either, but said audited financial statements clearly are more valuable than unaudited financial statements.

2.1.8 Differences between Auditor Intent and User Perceptions of Intent. Detailed examination of the focus group results reveals a serious disconnect between what auditors may believe they are communicating in an unqualified auditor's report and what users infer from that report. Focus groups consisting of users revealed a wide range of perceptions about what information is communicated but the source of the differences became more apparent during the focus group consisting of audit partners and managers. We found the auditor participants themselves had disagreements when describing the intended information content of unqualified auditor's reports.

In terms of intended communications, one auditor said the auditor's report gives the reader of the financial statements "comfort with the substance of the numbers." Another auditor said the auditor's report indicates the financial statements are fairly presented according to GAAP. A third auditor said he does not expect the user to even read the auditor's report, particularly because of its standardized language. He believes users generally understand auditors are not looking at the details of every number; however, they are not going to understand any details about what the auditors did from the auditor's report. A fourth auditor suggested the auditor's report is a "legal liability releasing" document for the auditor, but it is not as effective in releasing liability as a contractual agreement would be. He said the auditor's report is a "concluding document" that tells the client the auditor has fulfilled its responsibilities in accordance with the appropriate pronouncements and here is its conclusion. At its heart he said, "the auditor's report is something written by attorneys to limit or release liability."

This discovery of disagreement among auditors led to the question of whether there is some systemic lack of definition not addressed by the profession. To explore this, we attempted to determine the reasoning of the ASB in formulating the SAS No. 58 form of report. While there is very little documentation remaining relating to the deliberations, some information included with SAS No. 58 and personal communications with two then-Board members indicated the primary issues considered related to defining responsibility between management and the auditors. No consideration was discovered indicating any evaluation of specific user needs other than issuance of an opinion. We address this issue in section 3. Directions for Future Research.

2.2 Verbal Protocol Analysis (VPA)

The VPA research consists of two studies, each using the verbal protocol research method. For each study, an experimental task was completed by eight experienced financial analysts with a total of 16 different analysts participating. Both VPA Study 1 and Study 2 involved essentially the same task of assessing the per share value of a retail company going public via an initial public offering. In Study 1, a short form of report similar to that detailed in SAS No. 58 modified slightly for an Australian audience was provided as part of approximately nine pages of primarily financial information. In Study 2, analysts initially analyzed unaudited current year information and then were asked to reassess their per share valuation estimates when provided one of two types of auditor's reports—the unqualified short form report used in Study 1 and an unqualified, longer form ISA 700 report. Study 2 concluded with a questionnaire phase where analysts were queried about several aspects of auditor's reports such as their perceived effect of an audit on financial statement information reliability.

2.2.1 VPA Study 1. Study 1 finds that the auditor's report is attended to by all participants—that is, noted explicitly and, in most cases, read, either by scanning or by reading it in its entirety. Several analysts explicitly evaluated the report and noted its importance. As the analysts were attending to the financial information or were using that information as input to their valuation processes, most participants explicitly considered one or more 'qualitative characteristics' of financial information that may be affected by an audit. The most frequent characteristics mentioned were reliability and completeness, although references also were made to relevance, understandability, verifiability, and neutrality.

The typical decision process of analysts where the auditor's report is part of the available information set is for the analyst to assume the information meets some audited level of quality, presumably a 'high' level of assurance. While the unqualified auditor's report is attended to, it appears only to validate an individual analyst's inherent underlying assumptions about the quality of the financial statement information.

Study 1 thus provides some evidence that the audit and an unqualified auditor's report are important for the valuation of a company in a valuation task, but only in regard to the reliability of the financial information. No additional information useful for valuation purposes is provided by the auditor's report itself. These results generally are consistent with a significant amount of prior research on the value of the audit and the auditor's report to various market participants. For a summary of prior research, see Church et al. (2008).

2.2.2 VPA Study 2. Study 2 was designed to provide more detailed evidence on how analysts evaluate auditor's reports by separating the auditor's report from the initial valuation of the company. When participants were asked to use unaudited financial information to value a company, almost all looked for an auditor's report and asked why it was not there. Lack of an auditor's report clearly was seen as a 'red flag' in regard to the reliability of the financial information.

However, when an auditor's report was provided, neither the participants' valuations nor their confidence in their valuations was affected. They did want to know that the financial statements had been audited, but the actual auditor's report did not provide any further information relevant to their valuation process. As noted by one participant, "it doesn't actually give me any more information than what I've got."

There were a number of verbalizations reflecting the participants assessment of whether the audit report was unqualified or whether there were any exceptions noted (i.e., qualifications or other modifications). Consistent with the focus groups, once the opinion was established as being unqualified, further processing usually was not deemed necessary. Verbalizations of analysts who did explicitly examine the auditor's report further reflected this. One analyst who received the short-form report noted in his evaluation "mainly that there's lots of words and I can't be bothered reading to be honest." Another analyst in perusing the long form report stated "it is quite legalistic" and then, "I don't actually care about any of this."

After being provided the audit report, the analysts were asked to rate on a scale of zero to four how much assurance they perceived from the audit report. The mean response was 2.8, indicating they perceived the audit report to provide a relatively 'High', but not 'Absolute', level of assurance.[5] Interestingly, only one analyst questioned whether the audit report was issued by a Big 4 auditor or not (the audit firm level was not noted in the case), which does not indicate the level of importance on this issue that was suggested in the focus groups. As in Study 1, Study 2 provides evidence of the analysts attending to the qualitative characteristics of the financial information with reliability and completeness being the criteria most frequently considered.

The form of unqualified auditor's reports, i.e., short-form or long-form, made little observable difference in the analyst's decision processes and in their responses to possible effects of having audited information. Altogether, these results imply that analysts are concerned about the qualitative characteristics of financial information, but that in the analysts' usage of auditor's reports, the most important information simply is that an unqualified auditor's report accompanies the financial statements. With either auditor's report format, there was little further processing of any information provided in the report. One analyst who received the short-form auditor's report noted "if you see the new ones now they are huge," indicating he was aware of the ISA 700 form of report. He made no comment to indicate it was different in any significant aspect except for length. This result is consistent with the focus group discussions detailed above, that the auditor's report is viewed as a pass/fail, "check the box" document.

A number of specific questions also were asked to elicit analysts' perceptions about the auditor's report. Analysts were asked to rate their perceptions on a scale of zero to ten, with zero being not reliable and ten being very reliable, about the *reliability* of the unaudited information and then the reliability of the information after an auditor's report was provided. When four analysts were provided the short-form report, their assessment of the reliability of audited over unaudited information increased from an average of 4.8 to an average of 8.3, an increase in perceived reliability of 73 percent. When the other four analysts were provided with the long-form report, their assessment of reliability increased from 5.0 to 7.3, an increase in perceived reliability of 46 percent. While this sample is small and the rating scale is limited, a lower increase in perceived

[5] The scale was marked: 0 = None; 1 = Low; 2 = Medium; 3 = High; and 4 = Absolute.

financial information reliability associated with the long-form report does raise an issue that perhaps the extra information does not provide a higher level of assurance.

An issue highlighted from the focus group study was wide ranging views on the 'level of assurance' mainly related to the various groups' understanding of *materiality*. This was consistent with the findings in the VPA study. When analysts were asked whether all discovered errors were corrected prior to issuing the financial statements, half said yes. [6] Of the other four, three said five percent of net income and one thought an error up to 7.5 percent of net income could remain undetected. The analyst who suggested five percent also raised a concern about the practice of netting errors when deciding whether adjusting corrections are considered necessary, stating that "if there is ten going one way and eight going the other, they say it is immaterial."

The analysts then were asked to indicate on a scale of zero to ten their perception of auditor *neutrality*.[7] The combined response was quite high at 8.1, indicating a perception that auditors actually are independent from their clients and act without bias. The short-form auditor's report was assessed at a higher level of neutrality (9.0) than that for the long-form report (7.3). One possible reason for this is that the long-form report adds increased clarification of management's responsibilities. This addition actually may raise concerns about the reliability of the associated financial information by transferring the focus more toward management's influence and less toward the auditor. This was verbalized by one analyst who was provided the long-form report and stated "as the auditor always states they are relying on management's numbers, it is management's responsibility for preparing, so I would generally assume a moderate bias." Two analysts mentioned that non-audit fees were a problem for the neutrality of the auditor.

3. Directions for Further Research

The Request for Proposals states "Once the selected projects are completed, the ASB and IAASB anticipate funding additional research to identify and explore ways in which the auditor's report might be revised to communicate more clearly and to address identified user misperceptions." In this research project, we use primarily qualitative techniques to identify perceptions by and usefulness to various stakeholders of an unqualified auditor's report. As our focus groups and VPA subjects represent small populations of self-selected volunteers, they should not be considered to be a random, representative sample of the entire stakeholder population. Accordingly, caution should be exercised when generalizing from this research. In this section, we discuss specific information that should be considered for possible disclosure by auditors in conjunction with an unqualified auditor's report. However, we believe additional research is required before any changes are made to the existing forms of the auditor's report.

[6] One of the four had indicated a perceived level of assurance provided by the audit report to be 'Absolute.' The other three indicated a lower perceived level of assurance.

[7] For purposes of this study, auditor *neutrality* is discussed as being synonymous to auditor independence or absence of bias by the auditor.

3.1 Basis for Recommended Further Research

Our study indicates that an audit report *per se* is deemed "important" by a range of financial statement users and preparers. However, the exact message or messages communicated by the audit report was less apparent. Confusion over the message was a consistent theme in the focus groups that included both preparers and users of financial statements.[8] In the verbal protocol study very little attention or importance was placed by sophisticated financial report users on the contents of the audit reports. This lack of attention did not improve even when the verbal protocol study participants were provided with a "long form" audit report as recommended by ISA 700 (IAASB 2006b).

Overall, our findings suggest that this lack of interest in the audit report content is a joint function of confusion on the part of both auditors and users about the intended message of an auditor's report and homogeneity of the content of the that report. This is broadly consistent with previous research (e.g., Dillard and Jensen 1983; Pringle et al. 1990; Geiger 1994). Based on these findings, we believe several important questions need to be addressed through both policy decisions and rigorous further research.

3.1.1 What is the Intended Message? The primary policy decision needed is to define clearly the message the profession wishes to communicate by issuance of an unqualified auditor's report. Is the message intended to communicate assurance that an adequate audit was performed under appropriate standards, assurance that the associated financial statements adhere to a prescribed conceptual framework and appropriate principles, or both? Lack of clarity on this issue appears to be a source of confusion revealed by the various focus groups. As part of this policy decision, rigorous research should be conducted to provide supportive data to assist in aligning the intent of the profession in regard to the intended message with the perception of that message by financial statement users.

3.1.2 What is the Intended Level of Assurance Provided by an Unqualified Auditor's Report? Assuming the first question can be satisfactorily resolved, a related question is what level of assurance an unqualified auditor's report is intended to communicate in regard to the audit and/or the associated financial statements. For example, the auditor achieves a level of assurance about the financial statements from the results of audit procedures and interpretation of those results based on professional judgments. Is that the level of assurance intended to be communicated by the auditor's report? Focus group results indicate that at least some users apparently associate level of assurance with materiality. Our results, again which are consistent

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[8] It should be noted that deliberations by the ASB did not result in unanimous support for SAS No. 58 from the then-Board members. Of the eighteen members, four assented with qualifications and three dissented in regard to issuance at all. Communications with two of the then-Board members indicate an important objective was to clarify the division of responsibilities between the auditor and client management. However, disclosed comments by then-Board members also indicate disagreement about issues such as the level of assurance provided by the auditor's report and the degree of disclosure about materiality. The AICPA no longer has minutes of ASB meetings during that time period so deliberations about these issues cannot be examined.

with prior research (e.g. see Francis (2004)), also indicate that some users perceive differences in the level of assurance provided by different audit firms. Further research focusing on this question will be an important step in improving communications with users.

3.1.3 How Can Level of Assurance be Communicated? The third question follows resolution of the first two. That is, how can the level or levels of assurance be communicated? The auditor's level of assurance appears to be related to the estimated residual audit risk remaining after completion of the audit. How can that be communicated in a form useful to financial statement users? Additionally, how can a level of assurance in regard to adequacy of an audit be communicated? Conversely, would attempting to communicate various levels of assurance be overly confusing or have a dysfunctional effect on financial statement user perceptions. It is important that these issues be addressed through further research.

3.1.4 What Other Information Might Auditors Communicate in Conjunction with an Auditor's Report? Our fourth question relates to our findings in both the VPA studies and the focus groups that current forms of unqualified auditor's reports do not provide any specific information useful for financial statement users beyond that contained in the financial statements themselves. Focus group results were mixed overall on the desirability of the auditor making additional disclosures, but the analysts in both studies, who represent one primary category of users, were consistent is indicating more information and transparency would be highly desirable. We expand on this area in section 3.2 and provide additional ideas for needed further research to determine what, if any, additional information is useful, desirable, and appropriate and how such information might best be communicated.

3.2 Potential Items to Consider for Expanded Disclosure

In evaluating the nature of information indicated as desirable by participants in this study, it became apparent that much of that information currently is required to be communicated to management and to those charged with governance under SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA 2006b), SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA 2008), ISA 260, *Communications with Those Charged with Governance* (IAASB 2008) and ISA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (IAASB 2006). While the authors of this study do not have a legal background and no legal opinion has been obtained, prior court cases indicate there is the possibility that in the U.S., stockholders already may have legal access to such communications. In Delaware for example, Delaware Corporations Code §220 permits stockholder inspection and copying of a corporation's stock ledger, list of stockholders and "other books and records." Delaware courts have interpreted the phrase "other books and records" to cover a wide variety of corporate documents, including memoranda, e-mail, letters, minutes, resolutions, invoices, agreements, ledgers and other documents and even extends to the books and records of a corporation's subsidiaries (Brody et al. 2008). Similar rights exist in all other states.[9]

[9] Stockholder rights outside the U.S. likely vary by political regime. While our recommendations are directed primarily toward U.S. auditor's reports, similar disclosures could be included in

Relatively uncontrolled public disclosure of information that may be both complex and sensitive may not be in the best interests of the auditor, the audit client and its owners, or the financial statement users. It presently is not determinable for example, how public disclosure of auditor/client communications required under SASs No. 114 and 115, and ISAs 260 and 315 might impact user perceptions in regard to the level of assurance provided by an unqualified auditor's report.

Accordingly, we recommend that additional research be undertaken in regard to expanded disclosure of matters found to be important to financial statement users. Such information possibly could accompany the auditor's report in order to enhance its usefulness, help establish an intended level of assurance, and improve financial reporting transparency. Specifically, we recommend further research be conducted to focus on the impact on user perceptions of information similar to that required by SASs No. 114 and 115, and ISAs 260 and 315 and on specific information about selected audit procedures and judgments suggested by participants in this study. The following categories of information could be included in the detailed further research effort.

3.2.1 Information About the Audit. Included in the topics that might be disclosed, two appear to be particularly worthy of additional research and consideration—audit materiality and information about auditor neutrality or independence. Based both on focus groups discussions and the verbal protocol analysis, information regarding materiality may be the additional information most widely desired by financial statement users.

3.2.1.1 Materiality. One issue raised in the Request for Proposals was: "….some users may not understand the level of assurance intended to be conveyed by the auditor's report." Across focus groups the level of assurance generally was thought to be related to the concept of materiality. In fact, many in the auditor focus group felt the level of assurance and materiality essentially are the same thing. Financial statement user groups indicated only a vague understanding of the concept of materiality although all did seem to understand that auditors do not audit everything to every penny. Half the financial analysts in the VPA, however, thought the auditor would detect all misstatements. Neither focus group participants nor financial analysts in the VPA segment seem to have an idea of what the intended level of assurance or materiality actually is. As one CFO said, "materiality levels are more secret than the Coca Cola formula."

However, SAS No. 114 requires the auditor to inform those charged with governance as to "the implications of a failure to correct known and likely misstatements, if any, considering qualitative as well as quantitative considerations, including possible implications in relation to future financial statements." Similarly, ISA 260 requires the auditor to "inform those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole." Further research should examine the impact on user

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international standards with the caveat that local laws and regulations take precedence over the disclosure requirements.

decisions of disclosing uncorrected misstatements in conjunction with the auditor's report. Such research can include various methods of disclosure.[10]

3.2.1.2 Independence. Although the auditor's report affirms the auditor's independence, SAS No. 114 indicates that in some circumstances the auditor may determine that "it is appropriate to communicate circumstances or relationships (for example, financial interests, business or family relationships, or non-audit services provided or expected to be provided) that in the auditor's professional judgment may reasonably be thought to bear on independence and that the auditor gave significant consideration to in reaching the conclusion that independence has not been impaired." Similarly, ISA 260 requires the auditor to include a statement that the engagement team and others in the firm as appropriate have complied with relevant ethical requirements regarding independence. In addition, "all relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence" should be communicated. Per ISA 260, "This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity." The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level also could be communicated. Further research should examine the desirability of disclosing additional information about issues potentially affecting financial statement user perceptions of auditor independence and the corresponding perceived level of assurance provided by the audit.

3.2.2 Quality of the Financial Statements. Generally accepted accounting principles provide for an entity to make accounting estimates and judgments about accounting policies and financial statement disclosures. As discussed in SAS No. 114 (AICPA 2006b) and ISA 260 (IAASB 2008), open and constructive communication with those charged with governance about qualitative aspects of the entity's significant accounting practices may include comment on the acceptability of those practices. The auditor should discuss the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant policies as well as information on accounting policies used by similar entities. If the auditor disagrees with management in regard to significant accounting practices, the auditor should explain the basis for the disagreement and offer an explanation as to why an unqualified audit opinion still was appropriate. The discussion generally could include such matters as the consistency of the entity's accounting policies and their application, and the clarity and completeness of the entity's financial statements, which include related disclosures. The discussion also could include items related to the IASB and FASB Conceptual Framework (IASB and FASB 2009), such as the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements. Categories of items that may

[10] Disclosure of waived corrections of $51 million in of misstatements and the corresponding undisclosed $0.19 decrease in earnings per share in the 1997 audited financial statements of Enron (Brody et al. 2003; Turner 2007) may have resulted in discovery of Enron's financial difficulties well in advance of its subsequent collapse.

have such an impact include accounting policies, accounting estimates, and financial statement disclosures. Each of these categories is described more fully in SAS No. 114 and ISA 260

One banker thought it would be useful for auditors to disclose “highlights” of anything they thought was a significant change for the company whether the client disclosed it or not. The change could be in terms of presentation or significant changes in the numbers, such as specific expenses. Even if the client disclosed some significant change in the financial statement notes, if the auditor thought it was significant, the auditor should also mention it in their disclosure. As another banker said, “more transparency is better.” Analysts indicated they definitely would like to see information on key risk areas.

There was some discussion in the focus groups about adding granularity to the auditor’s report by the auditor issuing a “grade”, such as A, B, C, or F. CFOs seemed opposed to this idea because it would be difficult to determine what the grades mean and how they would change the liability profile or risk profile for the auditors. In a similar suggestion, a CFO suggested the audit be divided into five to ten different aspects and the auditor would provide a grade or rating on each of those items as part of their audit opinion. Some areas could be management, revenue, cost structure, distribution, etc. However, another CFO argued this may be going too far beyond the purpose of the audit, which the CFO suggested is to have an opinion on the accuracy of the financial statements.

Further research should examine how discussions of the client’s significant accounting policies may affect financial statement users perceptions of the level of assurance provided. Additionally, research should examine the potential impact of additional disclosures, such as those suggested by a banker participant, and possible methods of making those disclosures, such as adding granularity in some manner.

3.2.3 Quality of the Financial Reporting System. As noted previously, almost all participants in the CFO focus group were from public companies and have experienced the shift of ASB-based audits to PCAOB-based audits. All the CFOs seemed to believe the PCAOB-based audit is superior to the ASB-based audit with the PCAOB’s specific requirement for the auditor to express an opinion on the internal control over financial reporting being the big contributor to that perception. All the CFOs agreed that the Sarbanes-Oxley Act of 2002 and the PCAOB have significantly increased the cost of audits, but felt that PCAOB-based audits are more thorough and rigorous than prior audits.

SAS No. 115 (AICPA 2008) requires the auditor to communicate in writing to management and those charged with governance control deficiencies identified during an audit that upon evaluation are considered significant deficiencies or material weaknesses. Communications illustrated in SAS No. 115 to be provided to management and those charged with governance also could be a basis for disclosure to all users. Unless all of those charged with governance are involved in managing the entity, ISA 260 (IAASB 2008, ¶12(c)(i)) requires that material weaknesses in the design, implementation or operating effectiveness of internal control that have come to the auditor’s attention be communicated to management as required by ISA 315 (IAASB 2006a) or ISA 330 (IAASB 2007). As with SAS No. 115 required communications, ISA 260 required communications could be a basis for reporting financial reporting system weaknesses to stockholders.[11] Further research should examine not only the potential usefulness of internal control opinions for non-public entities, but also the usefulness of non-opinion-based disclosures such as those required under SASs No. 114 and 115, and ISAs 260 and 315.

Additional information not currently required to be communicated but indicated as being desirable by participants in our study includes the auditor's assessments of areas of high inherent risk (see SAS No. 107, §21, AICPA 2006a) and high risk of fraud (SAS No. 99, AICPA 2002) along with the reasons for those assessments. These assessments currently are documented in the audit workpapers, but are not required disclosure to others. As with internal control assessments, further research should examine methods of disclosing such risks to financial statement users and the impact of such disclosure on the perceived level of assurance provided by the auditor's report.

3.2.4 Quality of the Client as a Business Entity. User groups indicated that the auditor has access to relevant information about the viability of the audit client and specific risks faced by that client. Knowledge of that information would be valuable input into user's analysis of the financial statements. The focus groups seemed especially interested in more information regarding the going certain evaluation, while SAS No. 114 and ISA 260 refer to other risks that may be communicated.

3.2.4.1 Going Concern. User focus groups assumed that if additional language related to a going concern question is not included in the auditor's report, a going concern analysis was performed

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[11] Also, AU Section 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*, interpretation 17, *Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards* (AICPA 2006c) indicates an auditor may add language to the auditor's standard report regarding their limited internal control procedures. The sentence suggested by AU 9508.88 to include in the second paragraph is: *An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.*.

Similarly, AU Section 9508, interpretation 18, *Reference to PCAOB Standards in an Audit Report on a Nonissuer*, allows modification of the auditor's report to indicate that an audit was conducted in accordance with both GAAS *and* the PCAOB's auditing standards and to clarify that the purpose and extent of the auditor's testing of internal control over financial reporting was to determine the auditor's procedures and was not sufficient to express an opinion on the effectiveness of internal control. AU 9508.92 (AICPA 2004) provides a suggested sentence to include in the second paragraph: *The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly we express no such opinion.*

and the auditor concluded it was not an issue. There were differences in perception, however, between the user groups and the auditor group as to the degree of analysis performed. Auditors stressed that their going concern analysis consists of forecasting cash flows and other key financial data for one year to determine if the company likely will have sufficient liquidity to operate through that year. The auditors also stressed that when making a going concern evaluation, they do not evaluate management, the company's business model, the quality or competitiveness of products, etc. In other words, auditors do not perform an analysis that might be performed by a financial analyst, for example, to determine if a company is a good investment. It is not clear from the focus groups whether users of financial statements understand the rather limited scope of the auditor's going concern analysis. Thus, further clarification by the auditor appears warranted.

While the auditor's report already may be modified to express auditor concern about the entity's ability to continue as a going concern, both SAS No. 114 and ISA 260 indicate that among other items to communicate to those charged with governance, auditors should discuss the issues involved and related judgments made in formulating particularly sensitive financial statement disclosures such as those related to going concern evaluations. As the going concern auditor's report is one area where differences may exist between the nature and detail of audit procedures used by the auditors in evaluating going concern and user perceptions of those procedures, additional disclosures may be helpful. Further research can focus not only on the nature and detail of potential disclosures, but also on how a closer alignment of the auditor's intended level of assurance associated with a going concern unqualified auditor's report and user perceptions of that assurance can be achieved. Disclosure of the auditor's decision processes may be particularly important in light of changes currently being made by the Financial Accounting Standards Board in regard to the definition of going concern and the time period to be considered.

3.2.4.2 Other Business Risks. Appendix B to SAS No. 114 identifies related matters that may enhance communication, including the potential effect on the financial statements of significant risks and exposures, and uncertainties, such as pending litigation, that are disclosed in the financial statements; the extent to which the financial statements are affected by unusual transactions including nonrecurring amounts recognized during the period; the extent to which such transactions are separately disclosed in the financial statements; the factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets; and the factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. ISA 260 identifies in paragraph 11 significant matters subject to correspondence with management that may include such matters as business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.

Such information could be of interest to financial statement users and should be examined as to the usefulness to financial statement users and the impact of such disclosures on user's perceptions of the level of assurance provided by an unqualified auditor's report. As with other potential auditor disclosures, it is not clear which disclosures may result in a perception of greater assurance and which may have the opposite effect. Further research should focus on such issues.

3.3 Method Of Disclosure

One possible method of communicating these items would be to retain the current form of unqualified auditor's report and add a set of footnotes containing the additional disclosures. The report still would be addressed under current guidelines but would have a notation similar to that included on financial statements, e.g., "The accompanying footnotes are an integral part of this Independent Auditor's Report." Such footnotes would not replace the auditor communications to management or those charged with governance required under present pronouncements, but possibly could be in more condensed form. Further research should examine alternative methods of disclosing additional information about the audit and the audit client.

3.4 Final Comments

Our charge for this project as defined in the original Request for Proposals has been to examine user perceptions of the communications received by various classes of users through an unqualified auditor's report accompanying a set of financial statements. We believe that goal has been accomplished and we have suggested directions for future research that potentially could improve the usefulness of the auditor's report. Our study is innovative in that we talked to key stakeholders in the focus groups and also evaluated actual use of the auditor's report by sophisticated users in undertaking a company valuation in the verbal protocol study.

3.4.1 Primary Results. This study identifies several specific issues related to user perceptions of the level of assurance provided by unqualified auditor's reports and the impact of such reports on user decision processes. Identification of these issues, however, should be only the first step and we present the primary results in terms of needed additional research as follows:

- Auditors need to have an unambiguous definition of the level of assurance intended to be provided by an unqualified auditor's report and that intended level needs to be clearly communicated to financial statement users.

- The issue of materiality is found to be very important to users, but users have no basis for evaluating the impact of the underlying precision of audited financial statements. This is understandable since auditors have a great deal of flexibility in making materiality decisions based on professional judgment and those decisions are not disclosed either to management or to financial statement users. The desirability of disclosing some aspects of materiality and possible methods of disclosure and their usefulness should be examined.

- There are differences between auditor's apparent intended level of assurance regarding a client's ability to continue as a going concern and user's perceptions of that level of assurance. Disclosure of methodologies and assumptions made by auditors may be useful to financial statement users and should be investigated.

- Auditor's reports on internal controls such as those required for public companies in the U.S. appear to increase the level of assurance perceived by users. Research should

- Users may have a misperception of the auditor's assessment of fraud risk in regard to the level of assurance provided by the unqualified auditor's report. The degree of information that might be publically disclosed in regard to auditor's conclusions about the risk of fraud should be examined.

While public disclosure of such matters could be important both for valuation purposes and for corporate governance, it is important the impact on user perceptions of the level of assurance provided be investigated through further research. For example, it is not clear if some potential disclosures may result in users perceiving the reliability of financial statements to be greater while other disclosures decrease that perception.

3.4.2 Related Issues Requiring Research. Clearly, changes should not be made for the sake of change alone. The type of information that might be disclosed and the degree of detail to be communicated about that information should be considered carefully from several viewpoints. In that regard, we see six major, but separate, issues that require rigorous further research, policy debate, and legal analysis before changing the current form of auditor's report:

- How should the intended level of assurance provided by an unqualified auditor's report be defined, measured, and communicated to financial statement users?

- Of the various types of information that might be disclosed, which would be useful in decision-making, which might be confusing or misleading, in what form should the information be disclosed, and how would the perceived level of assurance be affected?

- What impact would public disclosures of items contained in SASs No. 114 and 115, and ISAs 260 and 315 have on communications previously assumed to be relatively privileged between auditors, client management, and those charged with governance? Would such disclosures result in auditors being less forthcoming with useful observations both in the type of information disclosed and the detail provided?

- While there was concern noted by participants that auditor liability could increase, public disclosures potentially could reduce the auditor's legal exposure by establishing a more clearly defined level of assurance. Before any additional disclosures are approved, it is important to examine how additional disclosures will affect the legal exposures of both the auditors and their audit clients. For example, is it possible that some form of safe-harbor law may be necessary to protect auditors and their clients?

- How will greater transparency about financial statement content and the audit process affect financial statement users' demands for a specific level of assurance and how can auditors respond to meet possible variations in demand?

- As all information suggested for consideration above already is required by existing professional guidance, it cannot be assumed that public disclosure will substantially increase audit costs or fees. Future research should examine potential increases in audit fees as this was an area of concern both for auditors and for CFOs in this research.

These issues and related sub-issues clearly require very careful examination from technical, behavioral, political and legal viewpoints. However, with the recent increases in required communications between auditors, management, and those charged with governance and the possible legal access to those communications by stockholders, it is imperative that such aspects be considered expeditiously. The outcome of the suggested further research topics could result in an auditor's report that is more than just a "checkmark of approval."

Respectfully submitted,

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