

**Auditor's Report – IAASB Working Group Report****Key Messages****General**

1. Auditors' reports are valued by users, and particularly as to whether the report is qualified or not.
2. The value of the unqualified audit report is mainly symbolic: it is valued due to its existence rather than its detailed content.
3. The audit expectations gap surrounding the scope and purpose of an audit of financial statements, and the auditor's role and responsibilities in that regard, is persistent and very hard to change.
4. User perceptions of the scope and quality of audits and their perceptions of quality of audit reporting seem inextricably linked.

**Specific Matters**

1. *Usefulness of the standard unqualified auditor's report (SAR)*: the current content of the SAR is not viewed as being useful. User perceptions about why it is not useful appear to be shaped by factors that relate to the form and content of the report. For example: the wording used in the report and language used to convey the messages auditors' intended messages, including use of technical language; lack of information about the particular audit performed and about the audit findings.
2. *Auditor communications*: Users would like additional reporting by the auditor of information and disclosures about the *audit performed* and also about *the audited entity*, but there is no clear consensus about what that information should be or its potential usefulness (i.e., what users would do with it if they had it). User perceptions about auditor reporting in general are also shaped by their expectations linked to the value of auditor communications more broadly, including regarding matters that go beyond the objective of an audit of financial statements.

**I. Background and Developments to Date**

1. ISA 700 was issued by the IAASB as a revised standard in 2004.<sup>1</sup> Subsequently, various commentators have pointed to the need to obtain an understanding of user perceptions about the SAR issued on audited financial statements. (See discussion in Section II)

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<sup>1</sup> The international standards on the auditor's report for a financial statement audit developed by the IAASB are contained in International Standard on Auditing 700 (ISA 700) "Forming An Opinion And Reporting On Financial Statements." ISA 700 issued in 2008 (effective for audits for financial periods commencing after 15 December 2009) is the redrafted 'clarity' version of the revised ISA 700 that was issued in 2004, replacing ISA 700 "The Independent Auditor's Report On a Complete Set of General Purpose Financial Statements" which existed prior.

2. In 2006 the IAASB and the AICPA's Auditing Standards Board (ASB) jointly commissioned four research studies with the broad aim of examining user perceptions about the SAR in international settings. The common research objective associated with the four studies was to provide insights into the nature of user perceptions regarding the financial statement audit and the auditor's report among various classes of financial statement and audit report users.<sup>2</sup>

### **Joint Meeting of the IAASB and AICPA ASB Working Groups**

3. A joint meeting of the IAASB and the AICPA ASB Working Groups was convened in October to receive and consider the final research reports (received in September 2009).
4. Additional objectives of the joint meeting were:
  - (a) To consider and discuss the final research reports, and evaluate the reported results and findings.
  - (b) To consider the reported research findings in the light of other relevant information about auditor reporting.
  - (c) To identify the key messages observable from the reported research findings and the other information considered (i.e., as a synthesis of key messages and common themes observable from all the information considered). The key messages identified are described in Section III, and summarized in Appendix 4.
  - (d) To identify, to the extent possible, views on possible courses of action for consideration based on the key messages identified, as a basis for each group's recommendations to the IAASB and the ASB respectively about future actions regarding auditor reporting.
5. At the meeting a representative of each research team provided an overview of the research performed and the results obtained, and answered questions that were asked about various aspects of the research.
6. Also at that meeting, members of the IAASB Working Group provided presentations on auditor reporting on financial statements as it has developed in the United Kingdom (UK) (Jon Grant, Auditing Practices Board), Japan (Tomo Sekiguchi, Accounting Standards Board of Japan), and France (Cédric Gélard, Compagnie Nationale des Commissaires aux Comptes, CNCC). (See further information in Section II)

## **II. Information Considered by the Working Group**

7. The information considered comprised:
  - (a) The final research reports provided in respect of the four IAASB/ASB commissioned research studies on user perceptions about the SAR; and

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<sup>2</sup> This initiative was primarily directed to gathering information about user perceptions of auditor's reports, and not with a view to identifying whether there is a need for modification of the SAR, or to consideration of wider auditor reporting questions or policy issues concerning auditor reporting or auditor communications more generally.

- (b) Other relevant contemporary information about auditor reporting and user perceptions thereof, including information about auditor reporting models applied in three countries abovementioned, and historical developments underpinning them.
8. The Working Group acknowledges that it has not carried out an exhaustive search to identify all possible sources of information about user perceptions of auditor reporting and audit reports. Therefore, other information relevant to this subject may exist that the Working Group has not considered. Nevertheless, the Working Group believes the initial set of information it considered, described here, provides an adequate initial base from which to draw some preliminary observations and recommendations. (See Sections III and IV respectively)
  9. The Working Group believes, however, that further actions or steps concerning auditor reporting that may be taken either as part of this project or a subsequent IAASB project, should be conditioned on an assessment of the need to obtain appropriate further information about the matters communicated in this Paper.
  10. For example, the Working Group notes the International Organization of Securities Regulators (IOSCO) Technical Committee’s Consultation Paper, “Auditor Communications” as a further source of current information about auditor reporting in the broader context of auditor communications with users, that may be considered in the light of the key messages reported from this project.

**Overview of the Research Studies of User Perception About the SAR**

11. The title of the final reports provided for each of the four research studies, and the authors of each report are given in the table below.

| Study <sup>3</sup> | Title of final report provided for each study  |
|--------------------|--|
| 1                  | “The Unqualified Auditor’s Report: A Study of User Perceptions, Effects on User Decisions and Decision Processes, and Directions for Future Research” (May 2009) <sup>4</sup>  |
| 2                  | “Report on Research Conducted in the United Kingdom and New Zealand in 2008 Investigating the Audit Expectation-Performance Gap and Users’ Understanding Of, and Desired Improvements To, the Audit Report” (Sept 2009) <sup>5</sup> |
| 3                  | “Investors’, Auditors’ and Lenders’ Understanding of the Message Conveyed By the Standard Audit Report” (Sept 2009) <sup>6</sup>   |
| 4                  | “Financial Statement Users’ Perceptions of the IAASB’s ISA 700 Unqualified Auditor’s Report in Germany and the Netherlands” (August 2009) <sup>7</sup>   |

<sup>3</sup> Numerical identifiers recorded against each of the research studies in the table has no relevance other than for identification purposes, to facilitate reference to the studies in this report and in the attached Appendices.

<sup>4</sup> Theodore. J. Mock, UC, Riverside and Maastricht University; Jerry L. Turner, the University of Memphis; Glen L. Gray, California State University, Northridge; Paul J. Coram, University of Melbourne.

<sup>5</sup> Brenda Porter, School of Business and Economics Exeter University, Faculty of Commerce and Accountancy, Chulalongkorn University, Bangkok; Ciarán Ó hÓgartaigh, Michael Smurfit Graduate School of Business, University College Dublin; Rachel Baskerville, School of Accounting and Commercial Law, Victoria University, Wellington.

<sup>6</sup> Steven K. Asare, University of Florida; Arnold Wright, Northeastern University.

12. The abstracts provided by the research teams for the studies are contained in Appendix 2.
13. A staff summary of the research studies contained in **Agenda Item 4-B** provides a comparative overview of the four studies.

**Other Relevant Information: Auditor Reporting Models Used in France, the UK and Japan**

14. The Working Group considered the auditor reporting model used in three national jurisdictions where auditing standard-setters/regulators have introduced changes to the standard auditor's report and/or the auditor reporting model in responding to user needs in their national settings.
15. The Working Group received presentations from its members from France, the UK and Japan explaining the unique aspects of the auditor reporting model used in each of these countries.
16. The Working Group considered the information about auditor's reporting in these three countries, particularly noting how the changes introduced in each country have attempted to respond to user or regulatory concerns about the usefulness of auditors' reports, or to improve the report through changes to its content and/or format.
17. The changes to the SAR used in these countries offers real examples of some ways that individual countries have pursued the goal of enhancing auditor reporting. The Working Group believes these examples are relevant further information for the IAASB to consider in reflecting on ways that the usefulness of auditor's report might be enhanced in the international context.
18. The remainder of this section briefly outlines some of the unique aspects of auditor reporting in each of these three countries.

*France*

19. Following a law change introduced into securities laws in France in 2003, the French Code of Commerce contains a specific requirement for the auditor's report of all entities to contain "justification of the auditor's assessments." An example of an auditor's report issued for the statutory audit of an entity's financial statements under French law is provided in Appendix 3.
20. In 2004 the CNCC developed technical guidance, subsequently endorsed by the relevant oversight authority, to assist the auditing profession in France to implement the new legal requirement. The CNCC's guidance addresses how the "justification of the auditor's assessments" should be inserted into the standard auditor's report (which is based on ISA 700). The additional wording contained in the report ("Part II" of the report) follows directly after the opinion paragraph ("Part I" of the report).
21. The CNCC considered that the assessments that ordinarily require "justification" by an auditor in the auditor's report are those that relate to:
  - accounting policies

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<sup>7</sup> Anna Gold, Rotterdam School of Management, Erasmus University; Ulfert Gronewold, Ruhr University, Bochum; Christiane Pott, University of Muenster.

- accounting estimates
- overall presentation of the financial statements.

The wording of each “justification” should explain the procedures the auditor has performed in respect of the relevant areas/aspects of the audit. The wording of the justification and the selection of matters for which the auditor justifies the auditor’s assessments is a matter of professional judgment.

22. The CNCC established the principle that descriptions of the auditor’s assessments in the report are not to be used to provide information about the financial statements that has not been disclosed by the entity itself in the financial statements. Accordingly all the auditor’s “justification of assessment” descriptions are referenced (or “anchored”) to a disclosure contained in the audited financial statements.
23. Also, the guidance requires auditors to include wording in the auditor’s report to emphasize for users that the “justifications” do not constitute any form of “piecemeal” opinion on the financial statements, and that the opinion is on the financial statements taken as a whole.
24. The guidance issued by the CNCC and endorsed by its oversight authority as “best practice” was replaced in October 2006 by a specific auditing standard endorsed by the Ministry of Justice. The auditing standard is in substance similar to the guidance.
25. In the CNCC’s view, the legal requirement for auditors to provide further information in their reports about certain aspects of the audit has had a number of identifiable benefits, including in recent times in the context of the global economic crisis.
26. Among the benefits identified, the “justification of the auditor’s assessments” acts as a driver for:
  - (a) The entity whose financial statements are audited to improve financial statement disclosures on significant matters affecting the financial statements in view of the fact that the auditor’s report highlights those matters in the “justification of assessments.”
  - (b) The need, on the other hand, for customized or non-standard wording in the auditor’s report, which requires the auditing firms to exercise stronger quality control over the auditor’s report and the wording it contains prior to issuance. However, such stronger quality control has a cost.

It was noted that an associated drawback that has developed over time is that the wording used for the “justification of the auditor’s assessments” in an auditor’s report over successive years tends to become a bit “boilerplate,” as it is often simply repeated in each year’s report.

### *The UK*<sup>8</sup>

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<sup>8</sup> An initial consultation undertaken by the UK Financial Reporting Council in 2007/2008, entitled “Promoting Audit Quality,” stimulated public discussion and debate about the quality and usefulness of auditor reporting in the UK. During the same period the APB undertook a public consultation on the form and content of the auditor’s report that, among other things, explored different audit report formats. The public feedback received provided the stimulus for a change to the format of the auditor’s report used in the UK (under the revised ISA 700 (United Kingdom and Ireland) which was issued in March 2009).

27. Over the last few years there has been pressure from UK institutional investors to change the wording of the SAR. In particular investors believe that:
  - (a) much of the standardized wording of the SAR is of no interest to them, and
  - (b) information that would be of interest is not contained in the SAR.
28. To address the first concern the APB developed a shorter version of the SAR that allows auditors to omit certain “boilerplate”- type language (for example that relating to the auditor’s responsibilities and the scope of the audit) from the auditor’s report, and to replace these sections of the report with a reference to the description of those matters located on the APB’s website (which description applies in respect of all audit reports issued in the UK). The revised format is optional, not mandatory, and some firms are exercising the option to use it while others are not.
29. To address the second concern the APB acknowledged the need for further research to examine if and how user preferences or needs regarding inclusion of narrative information in the auditor’s report might be accommodated. Specifically as regards:
  - Enabling users to have a better understanding of the entity’s business and the risks it faces;
  - Communicating to shareholders the important audit issues that arose on the audit, and how they were addressed; and
  - Using “emphasis of matter” paragraphs more effectively, and establishing thresholds to determine whether to report an “emphasis of matter.”

### *Japan*

30. In Japan, the historical development of the civil law commercial code led to the requirement for auditors of large entities to report on whether the financial statements are in compliance with the code, and its regulations and articles of incorporation. This reporting format (which continued for decades until abolished in 2007 pursuant to the promulgation of revised corporate laws in Japan) was essentially designed to help with the discharge of responsibilities by those charged with governance. The report was required to be publicly available under requirements of the commercial code.
31. Following introduction of US-type securities laws established in the mid-20th century, the auditor of an issuer of securities is required, to issue an audit report that reports on whether the financial statements are fairly presented in accordance with generally accepted accounting practice in Japan. This audit report is essentially similar to the ISA 700 report, but the law requires that it address additional matters, inter alia, the existence of any conflict of interest between the audited entity and the auditor, or the engagement partner.
32. The requirement to report on additional matters in the auditor’s report on the financial statements is seen as useful by some users in Japan, including in the “disciplinary” sense as underpinning to how auditors performed their audits. Other commentators expressed the view that there was no incremental value and that the additional disclosures undermined the usefulness of the auditor’s report because they tended to take the form of “boilerplate” language in the report.

### **Other Relevant Information: Recent Projects or Studies Undertaken Regarding Auditor Reporting**

33. The Working Group wanted to be able to understand the reporting findings of the research studies in the context of other information about auditor reporting, for example as provided in other recent studies or projects undertaken on auditor reporting, or auditor communications more broadly.
34. In addition to the literature reviews contained within the reports provided for the research studies, the Working Group noted the following recent initiatives in the area of auditor reporting and auditor communications:
- A research report by the University of New South Wales (UNSW) and Australian National University (ANU) “The Impact of New Audit Report Formats on Perceptions and Investment Decision-Making Judgments of Users” (2004), published by the Australian Auditing and Assurance Standards Board.  
  
This study reported on perceptions of users of auditor reports in Australia regarding use of different audit report formats.
  - A literature review and analysis of relevant academic research as summarized by Church, B.K, Davis, S.M and McCracken, S.A contained in the published journal article entitled “The Auditor’s Reporting Model: A Literature Overview and Research Synthesis.”<sup>9</sup>  
  
This study contained a literature review of prior academic research on auditor reporting. It also provides a synthesis of the research findings to provide insights into the auditor reporting model, auditors’ judgment and decision-making in relation to reporting and the content of the auditor’s report (including research on user perceptions about the auditor’s report).
  - The Audit Quality Forum in the UK initiated a dialogue on auditor communications and auditor reporting in one of its series of studies on topics related to Audit Quality.<sup>10</sup>
35. The Working Group also noted the following initiatives undertaken by regulatory bodies (with either national or international mandates):
- The UK Financial Reporting Council’s public consultation in 2006 on “Promoting Audit Quality” which led to publication of “The Audit Quality Framework” in 2008. Contemporaneous with the FRC’s initiative, the UK Auditing Practices Board (APB) published a Discussion Paper: “The Auditor’s Report: A Time for Change?” (December 2007). Following its consideration of the feedback received, the APB issued the new revised UK auditing standard on auditor reporting now in effect in the UK.<sup>11</sup>

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<sup>9</sup> Published in *Accounting Horizons* Vol. 22, No.1. pp 69-90.

<sup>10</sup> Institute of Chartered Accountants of England and Wales (ICAEW) Audit Quality Forum publication “Fundamentals - Auditor Reporting,” published February 2007.

<sup>11</sup> ISA 700 (UK and Ireland) “The Auditor’s Report on Financial Statements,” issued in March 2009.

- The U.S. Department of the Treasury's Advisory Committee on the Auditing Profession issued its Final Report in 2008 which contained a number of recommendations pertaining to auditor reporting which it requested the PCAOB to consider.<sup>12</sup>
- The Consultation Paper issued by IOSCO's Technical Committee, "Auditor Communications."<sup>13</sup> This consultation follows from IOSCO's public consultation on audit quality undertaken in 2007: "Roundtable on the Quality of Public Company Audits from a Regulatory Perspective."

The Working Group considers the IOSCO Consultation Paper as a further important source of information and basis for understanding contemporary user perceptions of auditor reporting (and perceptions of capital market investors/participants in particular), in the wider context of auditor communications.

### III. Key Messages About the SAR

36. As a general caveat, the Working Group notes that its analysis of the various individual items of information considered, including the four commissioned research studies, is that the information sometimes reflected quite diverse and, on occasion, even contradictory messages and findings. While the research studies reflected some areas of commonality or findings that were broadly similar in direction, there were also instances where the findings reported in one or two studies seemed apparently contrary to some of the key messages identified below,<sup>14 15</sup>
37. The Working Group nevertheless believes there is sufficient commonality within the set of information taken as a whole to be able to identify a number of key messages. Those messages are described below, broadly categorized as "general messages" about the SAR, and "specific messages" about views on the perceived usefulness of the SAR and views on auditor communications more widely. (Appendix 4 reflects the key messages in a summarized format with links to the various research studies.)

#### General Messages

38. General messages about user perceptions of the SAR are:
  - (a) Auditors' reports are valued by users, and particularly as to whether the report is qualified or not. (Appendix 4, #1 in "General Messages")

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<sup>12</sup> The PCAOB's Standing Advisory Committee subsequently undertook a number of initiatives related to auditor reporting, including a public consultation on proposals relating to signature of auditors' reports by the responsible engagement partner for an audit.

<sup>13</sup> IOSCO Technical Committee Consultation Paper, "Auditor Communications" (September 2009). <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD303.pdf>. Responses are requested by 15 January 2010.

<sup>14</sup> The Working Group's synthesis of key messages reflected in this Paper has been circulated to the research teams that produced the commissioned research studies.

<sup>15</sup> For example the research study undertaken by Asare and Wright (study #4) showed, in respect of the technical term "materiality," that the users involved in the study seemed to have a very congruent numerical perception of what is "material" in the context of a set of financial statements.

- (b) The value of the unqualified audit report is mainly symbolic, as the report is valued due to its existence rather than its detailed content. (Appendix 4, #2 in “General Messages”)
- (c) Users do not appear to read the auditor's report, but merely note the fact that it exists in relation to the audited financial statements of a particular entity in which they have an interest.

As a consequence, users' judgments and decisions about an audited entity appear to be generally unaffected by the detailed content and the format of the SAR. The challenge is how to improve the *communicative* value of the report (see also the specific messages in paragraphs 40 - 42).

- (d) The expectations gap is persistent and very hard to change. (Appendix 4, #3 in “General Messages”)

The expectations gap surrounding the scope and purpose of an audit of financial statements and the auditor's role and responsibilities in that regard, persists regardless of the explanations contained in the SAR about what an audit comprises, and about the respective roles of the auditor and the entity's management. Some aspects of the expectations gap do nevertheless appear to have changed over time (including some favorable change reported for one jurisdiction that featured in the research).<sup>16</sup> There is some evidence that the extent of the expectation gap is increased, not narrowed, by the added information included in the SAR about management and auditor responsibilities.

- (e) User perceptions of the scope and quality of audits and their perceptions of quality of audit reporting seem inextricably linked. (Appendix 4, #4 in “General Messages”).

Some hold the view that audit quality may be enhanced if auditors' reports contained more information of the type that users view as being useful or desirable for their purposes. However, there is no clear consensus about the types of additional information users would like the auditor to report on in the auditor's report, (or what users would do with the additional information if they had it). Broadly speaking, users appear to want additional reporting of matters that are covered by an audit of financial statements, and also of matters that are not currently covered by the audit of financial statements (see also the specific messages in paragraphs 41 and 42).

### **Specific Messages: Usefulness of the SAR and Auditor Communications**

- 39. The following specific messages were identified, broadly linked to views on the usefulness of the SAR and views on auditor communications more widely.
- 40. The current content of the SAR is not viewed as being useful. (Appendix 4, #5.1 in “Specific Messages”)

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<sup>16</sup> Research findings reported in the study undertaken by Porter et al. (study #2) reveal an apparent decrease in some areas of the expectations gap as measured in the UK in 2008 versus the same areas of the expectations gap as measured in 1999.

User perceptions about why the report is not useful appear to be shaped to some extent by factors that relate to the form and content of the report. For example:

- (a) The wording of the report (seen as “boilerplate”); the language used to convey messages the auditor wants to communicate to users, including use of technical language (i.e., there is lack of “shared meaning” of some terms used in the report). As a consequence, the auditor’s intended messages in the report are often not understood by users.
- (b) Regarding technical terms contained in the auditor’s report, examples of terms that users appear not to understand very well are:
  - “reasonable assurance”
  - “fairly present”/“true and fair view”
  - “material misstatements.”

41. Users perceive a lack of information in the report about the audit performed for the particular financial statements, and about the audit findings and the resulting level of assurance obtained in the audit. In the absence of such information, more sophisticated users feel they are unable to assess the level of confidence they can associate with the financial statements based on the audit.

Examples of the types of information users seem to want about the audit for a specific entity are:

- Circumstances or relationships that might bear on the auditor’s independence.
- Information about “audit materiality” i.e., levels of materiality applied on the audit to identify known or likely material misstatements in the audited financial statements.
- The level of assurance actually achieved in the audit.

42. Users would like additional reporting of information about the entity by the auditor within the auditor’s report on the audited financial statements. (Appendix 4, #6 in “Specific Messages”)

User perceptions about auditor reporting in general are shaped also by their expectations linked to the value of auditor communications more broadly, including regarding matters that go beyond the objective of an audit of financial statements.

For example:

- (a) The auditor should report to users on other matters of interest to users such as:
  - The quality of the entity’s financial statements and its financial reporting system (and internal controls).
  - The quality of the client as a business entity.
- (b) Information the auditor has about an entity as a result of performing the audit of the entity, and information reported on or disclosed to the audit committee, should be communicated to users as well.
- (c) Reporting to external parties in public interest situations (e.g., reporting to regulators in certain conditions).

43. The Working Group noted that corporate and securities laws in some countries have extended statutory audit reporting requirements to include additional reporting responsibilities for the auditor in relation to the audited entity. For example, in some countries the auditor also is required to report on whether the entity has kept proper accounts and records in compliance with relevant laws/regulations. Ordinarily these reporting responsibilities are sufficiently closely related to the audit work effort for the audit of an entity's financial statements to be able to be reported on pursuant to the audit of the financial statements.
44. In other countries, notably the United States and Japan, an additional reporting role has been established for the statutory auditor to report on matters that go beyond the audit of the entity's financial statements. For example, the Sarbanes-Oxley requirements applicable to issuers of securities registered on the US stock exchanges that have given rise to the integrated audit and associated reporting responsibilities. Two of the research studies reported that users perceive this type of audit as being more useful than the standard audit in the sense that they provide additional information about the effectiveness of the entity's internal controls related to financial reporting.

#### **IV. Possible Actions to Consider**

45. The Working Group believes (subject to paragraph 9) that the information and key messages obtained from this project to date are a useful preliminary basis for a further consideration of auditor reporting issues. As an initial step, the observed key messages provide a starting point for further discussion and consideration about how the issues they reflect might be addressed in a substantive and meaningful way. Taking a broad view, they offer an initial basis for considering the question of how to achieve better alignment between the standards that govern the auditor's report and users' reasonable expectations about what the auditor's report should provide with reference to the purpose and scope of an audit of financial statements.
46. The Working Group believes that as an immediate step it should obtain the IAASB's initial reactions to the information reflected in the identified key messages. It also considered how that information can best be used in the context of making recommendations to the IAASB about possible further actions.
47. At the outset the Working Group recognized that, as a matter of principle, suggestions that would in essence amount to applying further effort to improve or "tinker" with the language contained in auditor's reports, or "fine-tune" clarifications of the intended messages contained in the SAR, are unlikely to be a useful course of action.
48. Having identified that general principle, the Working Group's overall recommendation to the Board is that the information-gathering commenced through in this project should be extended through further activity designed to explore more fully the following questions:
  - (a) What specific additional information would be helpful from the perspective of specific users for the auditor to communicate in the auditor's report, in connection with the audit of an entity's financial statements, about either:
    - (i) The audit of the financial statements; or
    - (ii) The entity whose financial statements are audited.

- (b) What incremental usefulness would the auditor's report have if it contained the additional information users would like to have in the report i.e., in what way would the auditor's report become more valued by users?
- (c) Given the nature of the additional information that may be desired by specific users, whose responsibility should it be to provide such information? For example, management would be in a better position to provide information about the entity than would the auditor. Accordingly, is the information users would like to see in the auditor's report of a sort that can reasonably be reported on by the auditor on the basis of having performed the audit of the entity's financial statements?

The Working Group recognizes that answers to these questions will likely differ between types of user groups. Accordingly, the task of gathering this information would need to be organized with due consideration of categories of different user groups, their information needs and the perspectives they bring to their use of audited financial statements. Use of focus groups comprising the main types of user groups (e.g., investors, shareholders, financial institutions and other types of credit lenders, regulators) would probably be necessary.

- 49. As noted in paragraph 9, the Working Group's recommendation above is an important precursory step to a consideration of actions or decisions regarding the current form and content of the auditor's report and standards relating thereto.
- 50. In addition, the IOSCO Technical Committee's current consultation on the broader subject of auditor communications will likely provide information about these questions in relation to capital market participants. The Working Group considers that an evaluation of the key messages identified in this project against the results obtained from the IOSCO consultation would be a further useful step. With that in mind, it would be beneficial to make an approach to IOSCO's Technical Committee to inform it of the IAASB's project, and to discuss and explore possible ways that the information from the IAASB's and the Technical Committee's respective projects might be able to be utilized on a shared basis.
- 51. Regarding other possible actions, there is a range of courses of action that could be considered with a view to developing a deeper understanding of the identified key messages and associated implications. For example:
  - (a) Consultation with key user groups, either on a targeted basis (e.g., through small focus groups comprising different types of users), or on the basis of a wider public consultation.
  - (b) Undertaking further research in targeted areas. For example, to examine the implications of possible courses of action regarding the auditor's report in view of the key messages identified, and findings obtained from consultation with key user groups.
- 52. The Working Group believes there is certainly benefit in seeking information about whether the auditor reporting models used in France and the UK have delivered meaningful improvements or benefits for users of auditors' reports in those countries. The Working Group considers this as an attractive prospect in the context of being able to better understand the merits of those reporting models.

### **Matters for IAASB Consideration**

- Q1. What is the IAASB's view of the Key Messages identified from this project (Section III)? Does the IAASB believe that the information reflected in them points to one or more issues in relation to the SAR that may require a response or other type of action on a more prioritized basis? If yes, what are those issues?
- Q2. Does the IAASB agree with the principle that actions that would essentially amount to merely "tinkering with" or "fine-tuning" the current wording of the SAR are unlikely to be of significant incremental benefit?
- Q3. Does the IAASB support the Working Group's recommendation that further actions designed to obtain answers to the questions raised in paragraph 47 should precede consideration of further possible actions regarding the existing standards on auditor reporting? Does the IAASB consider it important to identify key user groups as a basis for obtaining a deeper understanding of perspectives of different types of users?
- Q4. Does the IAASB think there are other questions associated with the identified key messages that should also be explored, for example, through further consultation or research?
- Q5. Does the IAASB agree that further information should be obtained about users' perceptions of the auditor reporting models used in France and the United Kingdom? If so, should this project be extended to identifying possible ways of doing that?
- Q6. Does the IAASB agree with the Working Group's recommendation that an approach should be made to the IOSCO Technical Committee to inform the Committee about this project and the initial results obtained from it concerning the SAR? Does the IAASB consider that developing a basis for sharing information with IOSCO in the context of its current consultation on auditor communications is a useful further step?

## Appendix 1

### List of Information Sources Considered

- “The Auditor’s Reporting Model: A Literature Overview and Research Synthesis” (2008) Accounting Horizons, Vol. 22 No.1. pp 69-90. Church, B.K, Davis, S.M and McCracken, S.A.
- Auditing and Assurance Standards Board (AAASB). Research Report by the UNSW and ANU “The Impact of New Audit Report Formats on Perceptions and Investment Decision-Making Judgments of Users” (2004)
- ICAEW “Audit Quality: Fundamentals –Auditor Reporting” Audit and Assurance Faculty Paper (2007)<sup>17</sup>
- IOSCO Technical Committee. Consultation Paper “Auditor Communications” (2009)<sup>18</sup>
- ISA 700, “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements” (December 2004)
- U.S. Department of the Treasury Advisory Committee on the Auditing Profession “Final Report” (2008)<sup>19</sup>
- UK APB:
  - Discussion Paper “The Auditor’s Report: A Time for Change?” (2007)
  - Feedback Paper on “The Auditor’s Report: A Time for Change?” Discussion Paper and APB Future Plans Regarding the Form and Content of UK Auditor’s Reports (2008)

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<sup>17</sup>[http://www.icaew.com/index.cfm/route/144970/icaew\\_ga/Technical\\_and\\_Business\\_Topics/Thought\\_leadership/AuditQuality\\_Forum/January\\_2007\\_Auditor\\_reporting/pdf](http://www.icaew.com/index.cfm/route/144970/icaew_ga/Technical_and_Business_Topics/Thought_leadership/AuditQuality_Forum/January_2007_Auditor_reporting/pdf)

<sup>18</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD303.pdf>

<sup>19</sup> <http://www.treas.gov/offices/domestic-finance/acap/index.shtml>

**IAASB/AICPA ASB-Commissioned Research Studies Author's Abstracts**

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

May 2009

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**AUTHORS' ABSTRACT**

The objective of this research project was to identify and provide information about users' perceptions of the unqualified financial statement audit. It comprised two related studies. The first study conducted focus groups with a number of important user groups and auditors to evaluate perceptions concerning an unqualified auditor's report (a total of 53 individuals participated). The second study was performed using verbal protocol analysis with financial analysts and examined the effects of unqualified audit reports on analysts' decisions and judgments (a total of 16 analysts participated).

Overall the research found that the audit report *per se* is deemed important by users. However, there was very little interest in reading the actual content of the audit report by any user group. In part, it seemed this was due to the homogeneity of the content of an unqualified audit report. Some participants suggested that an adequate replacement for the current auditor's report could be a simple auditor's "checkmark of approval." In summary, it seems that users have a preconceived understanding of the "meaning" of an unqualified audit report, and once this fact is confirmed, there is no need for further evaluation of the report. These findings were consistent across the SAS No. 58 audit report and the new longer form ISA 700 audit report.

However, despite this lack of interest in the content of the audit report, there were some areas where user groups were incorrect or confused about the exact message the audit report was intended to convey. These included information on level of assurance and materiality; independence; quality of the financial statements; quality of the financial reporting system; and quality of the client as a business entity.

***Report on Research Conducted in the United Kingdom and New Zealand in 2008 Investigating the Audit Expectation-Performance Gap and Users' Understanding Of, and Desired Improvements To, the Audit Report.***

September 2009

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**AUTHORS' ABSTRACT**

As a result of many high profile corporate debacles, criticism and a loss of confidence in external financial statement audits has characterized the auditing arena for many years. The criticism and loss of confidence in the audit function result from a mismatch or gap between society's expectations of auditors and what they perceive auditors deliver (i.e. the audit expectation-performance gap). The most visible element of a financial statement audit is the auditor's report and part of the mismatch between society's expectations of auditors and what it perceives they deliver may result from financial statement users and other interested parties failing to understand the messages conveyed by an auditor's report.

Against this background, the research investigated:

- (i) the structure, composition and extent of the audit expectation-performance gap in the United Kingdom (UK) and New Zealand (NZ) in 2008 and how this differed from the gap which pertained in NZ in 1989, 1999 and 2008, and in the UK in 1999 and 2008; and
- (ii) financial statement users' understanding of the message(s) conveyed in standard unqualified audit reports and changes to the format and wording of auditors' reports desired by society – in particular, by financial statement users.

The research found that, although the structure and composition of the audit expectation-performance gap in the UK and NZ in 2008 were similar, the gap was significantly wider in NZ than in the UK. In 1999, the extent of the gap in the two countries was essentially the same but, between 1999 and 2008, the gap in the UK narrowed substantially while that in NZ widened slightly. The research findings suggest that this difference may result from differences in the monitoring of auditors' performance in the UK and NZ and/or from greater societal awareness of, through greater publicity given to, corporate and financial reporting issues in the UK.

The research also found that, notwithstanding the use of the long form audit report as an educational tool for nearly two decades, financial statement users' (and other interest groups') misunderstanding of auditors' responsibilities and the audit function persists. This finding is supported by a further finding of the research – that the content of a standard auditor's report has little impact on financial statement users' understanding of the messages conveyed in the report.

***Investors', Auditors' and Lenders' Understanding of the Message Conveyed By the Standard Audit Report.***

September 2009

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**AUTHORS' ABSTRACT**

The purpose of this study is to evaluate the extent to which there are communication gaps among auditor and user groups in their understanding of the macro (i.e., objectives and limitations) and micro (technical terms) implications of the standard audit report (SAR). In a controlled automated internet-based experiment, auditors, bankers and investors reviewed background information on a hypothetical private company that had received a SAR. They then answered a series of questions that focused on the objectives, limitations, and technical terms in the SAR. We classify between group differences as being consistent with one of three patterns: (i) the user groups differ from the auditor group ("type I gap"); (ii) one user group and the auditor group differ from the other user group ("type II" gap); and (iii) the user groups differ from each other as well as from the auditor group ("type III gap").

We found that users consider the SAR to be relatively more important in assessing that the financial statements are free from material fraud than auditors. We also found that the SAR leads users to have a higher level of confidence about company management, investment soundness of a company, whether the company is likely to meet its strategic goals, and the likelihood that auditors have detected material fraud in the financial statements. Finally, while auditors assess the likelihood that material frauds have been detected at about 60%, users assess a relatively lower likelihood of detection at 44%. Investors find SAR to be of higher importance for making investing decisions than auditors and bankers but the investors also have relatively lower confidence that the presence of SAR will assure viability.

With respect to the micro focus, there was one type I gap (auditors indicated they should use a relatively lower percent of net income for materiality than the users), 6 type II gaps, with bankers and auditors having shared meanings, and 1 type III gaps.

Taken together, these results show that the current SAR results in important type I communication gaps, and there remains an absence of shared meaning on the objectives and limitations of the SAR. A potential vehicle for narrowing these type I communication gaps is to add a statement in the SAR that the audit does not address governance risk, strategic risk or investment soundness risk. The prevalence of type II gaps in the micro-analysis suggests a potential for opportunistic interpretation of the technical terms, which suggests less urgency in revising or eliminating those terms.

***Financial Statement Users' Perceptions of the IAASB's ISA 700 Unqualified Auditor's Report  
in Germany and the Netherlands***

August 2009

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**AUTHORS' ABSTRACT**

The issuance of an unqualified audit opinion means that the auditor believes that the financial statements give a true and fair view in accordance with the applicable financial reporting framework (IFAC, 2008). Prior research demonstrates that financial statement users (such as investors and analysts) often associate an absolute level of assurance when they read such messages, potentially resulting in often naïve or unreasonable expectations (e.g., Epstein and Geiger, 1994). The first purpose of this study is to investigate whether financial statement users, as compared to experienced auditors, ascribe relatively more responsibility to the *auditor* than to *management*, and whether such a disconnect still holds under the revised version of ISA 700. Our second objective is to investigate the difference between experienced auditors' and financial statement users' perceptions concerning the reliability of audited financial statements. Furthermore, we investigate whether providing a complete auditor's report versus a short-form opinion-only version affects the expectation gap. We report on the results of an experiment, in which experienced auditors and users (i.e., financial analysts as sophisticated users and students as unsophisticated users) read a brief company description, a summary of the firm's financial statements, and an audit report, the latter of which we manipulated as being either the complete auditor's report according to the revised ISA 700 or a short-form audit opinion-only version. We find strong evidence for a persisting audit expectation gap between auditors and financial statement users under the revised ISA 700 auditor's report. Also, results are robust in indicating that the detailed explanations of the ISA 700 auditor's report of auditor versus management responsibilities and the task and scope of the audit are not effective in reducing this expectation gap, and partially even have a detrimental effect.

## The French Auditor's Report

**French legal requirement as introduced in 2003 by “Financial Security Law”:**

**Article L823-9 of French Code de commerce:**

*“The statutory auditors certify, justifying of their assessments, that the financial statements give a true and fair view of the results of operation during the year and of the financial position as of the end of the fiscal year.*

*When an entity prepares consolidated financial statements, the statutory auditors certify, justifying of their assessments, that the consolidated financial statements give a true and fair view of the financial position and of the results of operation of all the entities included in consolidation.*

*(...)”*

### Example of French Auditor's Report

**The example hereafter illustrates how the “Justification of assessments” paragraph has been used in the context of the financial crisis**

**Statutory Auditors' report on the consolidated financial statements**

*This is a free translation into English of the Statutory Auditors' report on the consolidated financial statements issued in the French language and is provided solely for the convenience of English speaking users. The Statutory Auditors' report on the consolidated financial statements includes information specifically required by French law in all audit reports, whether modified or not. This information presents below the opinion on the consolidated financial statements and includes explanatory paragraphs discussing the auditors' assessments of certain significant accounting and auditing matters.*

*These assessments were made for the purpose of issuing an audit opinion on the consolidated financial statements taken as a whole and not to provide separate assurance on individual account captions or on information taken outside of the consolidated financial statements.*

*This report on the consolidated financial statements should be read in conjunction with, and is construed in accordance with, French law and professional auditing standards applicable in France.*

To the Shareholders,

In accordance with our appointment as Statutory Auditors at your Annual General Meeting, we hereby report to you for the year ended December 31, 2008 on:

- the audit of the accompanying consolidated financial statements of Renault;
- the justification of our assessments;
- the specific verification required by law.

The consolidated financial statements have been approved by the Board of Directors. Our role is to express an opinion on these financial statements, based on our audit.

## I. OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

We conducted our audit in accordance with professional standards applicable in France. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, using sample testing techniques or other selection methods, evidence supporting the amounts, and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made, as well as evaluating the overall financial statement presentation. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the assets and liabilities and of the financial position of the Group as at December 31, 2008 and of the results of its operations for the year then ended in accordance with the IFRSs as adopted by the European Union.

## II. JUSTIFICATION OF ASSESSMENTS

In accordance with the requirements of article L. 823-9 of French Company Law (*Code de commerce*) relating to the justification of our assessments, we bring to your attention the following matters:

- For the purpose of preparing the consolidated financial statements, Renault group management makes certain estimates and assumptions concerning, in particular, the value of certain asset, liability, income and expense accounts. **Certain accounting estimates used in the preparation of the consolidated financial statements for the year ended December 31, 2008 were made in a context of economic crisis, leading to reduced visibility of the future and creating conditions specific to this year for the preparation of the financial statements. These general conditions are summarized in note 2-B to the consolidated financial statements. The following consolidated financial statements captions have been valued in an uncertain context:**
  - intangible assets and Property, Plant and Equipment (notes 2-L and 12),
  - investments in associates (notes 2-L, 13 and 14),
  - second-hand vehicles held in inventories and leased vehicles recorded in property, plant and equipment or inventories, depending on the term of the related contracts (notes 2-G, 11-B and 15),
  - sales financing receivables (notes 2-G and 16),
  - deferred tax assets (notes 2-I and 9).
- For all the items detailed above, we assessed the appropriateness of the accounting rules and methods applied and disclosures provided in the notes to the financial statements; we reviewed the consistency of the underlying assumptions, the quantified impact thereof and available documentation and assessed on this basis the reasonableness of estimates made;
- Finally, based on procedures performed and information communicated, we believe that note 26-B1 provides appropriate disclosures of the Group's exposure to liquidity risk;

- Your company also makes estimates regarding, in particular, vehicle warranty provisions (**note 2-G**), provisions for pensions and other long-term employee benefit obligations (**note 20-C**) and workforce adjustment provisions (**note 7-A**). For all such estimates, we reviewed the available documentation and assessed the reasonableness of the assessments made;
- As disclosed in **note 13-A** to the consolidated financial statements, the Group accounts for its investments in Nissan under the equity method; our audit of the consolidation scope included a review of the factual and legal aspects of the Alliance which serve as the underlying basis for this accounting method;
- As part of our assessment of the accounting methods applied by the Group, we have reviewed the methodology adopted for the capitalization of development costs as intangible assets, their amortization and the verification of their recoverable amount and we satisfied ourselves that these methods were properly disclosed in **notes 2-J and 11-A**.

**Such assessments were performed as part of our audit approach for the consolidated financial statements taken as a whole and contributed to the expression of our opinion in the first part of this report.**

### **III. SPECIFIC VERIFICATION**

In accordance with legislation, we also verified the information presented in the Group management report.

We have no matters to report regarding its fair presentation and consistency with the consolidated financial statements.

**Key Observations Derived from Information Considered by the IAASB and AICPAASB Working Groups on User Perceptions of the Standard Audit Report**

| #  | GENERAL MESSAGES  | Reference to four studies                   | Other research reports considered* |
|----|---|---|------------------------------------|
| 1. | <b>Audit reports are valued by users, particularly in the context of whether the report is qualified or not.</b>  | #1, 2, 3                                    | AH, Aus                            |
| 2. | <p><b>Users largely view the unqualified auditor's report as having only symbolic value i.e., it is useful only in the context of its existence.</b></p> <p>2.1 Somewhat conflicting information/evidence about whether different forms of reports improve usefulness of the report – e.g. providing more information or less; using different reporting formats. A range of different formats were canvassed in the studies (including testing of some alternative formats).</p> <p>2.2 The challenge is how to improve the communicative value of the auditor's report:</p> <p>(a) without creating further confusion for users.</p> <p>(b) without use of further “boilerplate” in the report, so that users will actually read the report rather than simply apply their preconceived understanding about what the report says irrespective of what it actually does say.</p> | #1, 2<br><br>#1, 2, 3, 4<br><br>#1, 2, 3, 4 | AH<br><br>AH, Aus<br><br>AH        |
| 3. | <p><b>The audit expectations gap surrounding the scope and purpose of the audit of financial statements is persistent and very hard to change</b> (including with respect to expectations about auditor's responsibility concerning fraud).</p> <p>3.1 Some aspects of the audit expectations gap appear to have improved in some countries (e.g. In UK: better monitoring of performance of audits; increased communication and education effort/press commentary about audits; role of the auditor).</p> <p>3.2 There is some evidence that the extent of the expectation gap has increased, not narrowed, by the added information in the SAR about management and auditor responsibilities.</p>   | #1, 2, 3, 4<br><br>#2<br><br>#4             | AH, Aus<br><br><br>                |
| 4. | <p><b>User perceptions of the scope and quality of audits and their perceptions of quality of auditor reporting seem inextricably linked.</b></p> <p>4.1 Evidence on the extent to which users use the report to inform their judgments and decisions about the audited entity: Linked to users' perception about the quality of the audit (also linked to perception about quality of the auditor).</p> <p>4.2 There is no clear consensus about what additional information users would like the auditor's report to contain. Some conflicting information about whether additional information improves the usefulness of the auditor's report in users' eyes.</p>   | #1, 2, 4                                    | AH, Aus                            |

| <b>SPECIFIC MESSAGES:<br/>USEFULNESS OF THE AUDITOR'S REPORT</b> |   | Reference to<br>four studies      | Other research<br>reports<br>considered* |
|--|---|-----------------------------------|--|
| <b>5.</b>  | <b>The current content of auditors' report is not viewed as useful</b>  | #1, 2, 3                          | AH,<br>Aus                               |
| 5.1  | Use of boilerplate language – so users do not read report<br><i>Comment: See auditor's reporting model introduced recently in the UK</i>  | #2, 3                             | AH,<br>Aus                               |
| 5.2  | Auditors' intended messages in the report are not understood by users   | #1, 2, 3                          | AH,<br>Aus                               |
| 5.3  | Inclusion of more information in the similar boilerplate style ("clarifications") is not useful; may further undermine users' view of the usefulness of the report  | #1, 4                             | AH,<br>Aus                               |
| 5.4  | However, it is also suggested that some additional clarifications about the audit might be needed to assist users to have a better understand about what the audit delivers. For example: scope of auditor's responsibilities for detecting fraud   | #3                                | AH,<br>Aus                               |
| 5.5  | Users do not understand technical terms used in the report, e.g. <ul style="list-style-type: none"> <li>• <i>Reasonable assurance</i></li> <li>• <i>Fairly present/true and fair view</i></li> <li>• <i>Material misstatements</i></li> </ul>   | #1, 3<br>#1, 3<br>#3<br>#3        |  |
| 5.6  | The report does not tell users about the <b>audit</b> performed for the specific entity. Users believe the value of the report can be increased by inclusion of more information specific to the <b>audit of the entity</b> . For example:<br><i>Materiality</i> – uncorrected misstatements<br><i>Independence</i> – circumstances or relationships that might bear on independence<br><i>Level of assurance</i> actually achieved in the audit/ <i>level of confidence</i> that users can associate with the audit report based on the audit performed<br>Interaction between audit materiality and the level of assurance is misunderstood<br><i>Comment: See example of the auditor's reporting model required for statutory auditor's reports in France.</i> | #1<br><br>#1<br>#1, 2<br>#1<br>#1 | Aus<br><br>AH                            |
| 5.7  | Users believe auditors know a lot about the company from the audit; information that users believe they would also like to know.  | #1                                |  |

| <b>SPECIFIC MESSAGES:<br/>AUDITOR COMMUNICATIONS</b> |  | Reference to<br>four studies | Other research<br>reports<br>considered |
|--|--|------------------------------|---|
| <b>6.</b>  | <ul style="list-style-type: none"> <li>• <b>Users would like additional reporting by the auditor.</b> For example on:</li> </ul>   | #1, 2                        | AH,<br>Aus                              |
| 6.1  | <ul style="list-style-type: none"> <li>• Quality of the financial statements</li> <li>• Quality of the financial reporting system</li> <li>• Quality of the client as a business entity</li> </ul> <p><i>Comment: Reporting on matters such as in 5.2.1 above would entail extending the scope of the audit engagement beyond the financial statements as the only subject matter of the engagement.</i></p>             | #1, 2                        | AH,<br>Aus                              |
| 6.2  | <p>Disclosure of information/messages communicated to the audit committee of the audited entity</p> <p><i>Comment: The type of disclosure suggested in 5.2.2 would mean changing the auditor's reporting model to include disclosure of "additional matters" in the auditor's report on the financial statements, in addition to stating the auditor's opinion on those financial statements.</i></p>                    | #1                           | AH                                      |
| 6.3  | <p>Reporting to external parties in public interest situations (e.g. reporting to regulatory authorities in certain conditions)</p> <p><i>Comment: The type of reporting suggested in 5.2.3 would mean extending the scope of auditors' communications to include other reporting obligations (e.g. reporting to a third party/regulator) in addition to the usual auditor's report on the financial statements.</i></p> | #2                           |   |

\* The references contained in this Table are to the following sources:

**# 1 – 4:** The four IAASB/AICPA commissioned research studies

**Aus:** AAASB. Research Report by the UNSW and ANU "The Impact of New Audit Report Formats on Perceptions and Investment Decision-Making Judgments of Users" (2004)

**AH:** "The Auditor's Reporting Model: A Literature Overview and Research Synthesis" (2008) Accounting Horizons, Vol. 22 No.1. pp 69-90. Church, B.K, Davis, S.M and McCracken, S.A.