

Agenda Item 4-B

Staff Summary of Four IAASB/AICPA Commissioned Research Studies on User Perceptions of the Standard Unqualified Auditor’s Report (For Reference Purposes – Extracts Only)

#	RESEARCH REPORT TITLE
1	<i>The Unqualified Auditor’s Report: A Study of User Perceptions, Effects on User Decisions and Decision Processes, and Directions for Future Research.</i> May 2009.
2	<i>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.</i> September 2009.
3	<i>Investors’, Auditors’ and Lenders’ Understanding of the Message Conveyed By the Standard Audit Report.</i> September 2009.
4	<i>Financial Statement Users’ Perceptions of the IAASB’s ISA 700 Unqualified Auditor’s Report in Germany and the Netherlands.</i> August 2009

A. RESEARCH OBJECTIVE

#1 Mock et al.	#2 Porter et al.	#3 Asare & Wright	#4 Gold et al.
<p>The project has two primary objectives:</p> <p>(i) 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.</p> <p>(ii) 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.</p>	<p>The research was conducted with the following objectives:</p> <ol style="list-style-type: none"> 1. To ascertain the structure, composition and extent of the audit expectation-performance gap in the UK and NZ in 2008; 2. To identify and explain differences in the structure, composition and extent of the audit expectation-performance gap: (a) in the UK and NZ in 2008 (a cross-cultural study) and (b) in NZ in 1989, 1999 and 2008, and in the UK in 1999 and 2008 (longitudinal studies); 3. To ascertain society’s (and, more particularly, financial statement users’) understanding of the message(s) 	<p>The purpose of this study is two-fold.</p> <p>First, we evaluate the extent to which there is congruence (or alternatively a communication gap) among three stakeholder groups in their understanding of the objectives and limitations of the SAR. We refer to this as a “macro” analysis because of its broad focus on the roles and responsibilities of the auditor.</p> <p>Second, we evaluate the extent to which there is congruence in the stakeholders’ interpretation of technical language used in the SAR. We refer to this as a “micro” analysis because of its focus on specific terms and concepts. The stakeholders chosen for the study are auditors (representing the issuers of the SAR) and</p>	<p>1. <i>To investigate whether financial statement users, as compared to experienced auditors, ascribe relatively more responsibility to the auditor than to management, and whether this still holds under the revised version of ISA 700.</i></p> <p>Several prior studies have found that users attribute disproportionate responsibility toward auditors, whereas in reality, management, rather than the auditor, is largely responsible for the adequacy of the financial statements. The first purpose of this study is to investigate whether financial statement users, as compared to experienced auditors, ascribe relatively more responsibility to the <i>auditor</i> than to <i>management</i>, and whether this still holds under the revised version of ISA 700.</p>

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#1 Mock et al.	#2 Porter et al.	#3 Asare & Wright	#4 Gold et al.
	<p>conveyed in a standard unqualified auditor's report;</p> <p>4. To identify changes to the format and wording of audit reports desired by society (and, more particularly, financial statement users).</p> <p>[Research Objectives 3 & 4 above encompass the two parts of the research that investigated the standard auditor's report:</p> <p>First part: To ascertain financial statement users' understanding of the messages conveyed by standard unqualified auditors' reports.</p> <p>Second part: To establish the changes to auditors' reports that financial statement users (and other interest groups) consider would make the reports more useful.]</p>	<p>investors and lenders (representing two important user communities).</p>	<p>2. <i>To investigate the difference between experienced auditors' and financial statement users' perceptions concerning the reliability of audited financial statements.</i></p> <p>Our second objective is to investigate the difference between experienced auditors' and financial statement users' perceptions concerning the reliability of audited financial statements. We investigate these different facets of the expectation gap based on the revised version of ISA 700, which is provided to the participants in its complete form.</p> <p>3. <i>To investigate whether providing a complete auditor's report versus a short form opinion-only version affects the expectation gap.</i></p> <p>The research study investigated whether providing a complete auditor's report versus a short form opinion-only version affects the expectation gap. Prior research has found that a complete audit report leads to a better understanding of the scope, nature and significance of the audit procedure. The provision of a complete auditor's report (compared to a short-form audit opinion-only version) should thus reduce the overall expectation gap between auditors' versus financial statement users' perceptions concerning (1) ascribed responsibilities toward the auditor versus management and (2) financial statement reliability. With respect to auditors, providing a complete auditor's report versus an opinion-only version should not affect their assessments, since professional auditors already know the exact</p>

#1 Mock et al.	#2 Porter et al.	#3 Asare & Wright	#4 Gold et al.
			<p>meaning of an unqualified audit report. However, as for the financial statement users, a comparison between perceptions based on the complete report versus the short-form opinion-only version will indicate whether the additional information provided in the complete audit report according to the revised ISA 700 is effective in aligning users’ perceptions with those of auditors and thus in reducing the audit expectation gap.</p>

B. RESEARCH DESIGN: RESEARCH METHODOLOGY APPLIED

#1 Mock et al.	#2 Porter et al.	#3 Asare & Wright	#4 Gold et al.
<p>The research examines two sets of the possible forms of unqualified auditor’s reports.</p> <p>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—<i>Reports on Audited Financial Statements</i>, 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.</p> <p>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), <i>The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements</i>, issued by</p>	<p>The research design for the research that investigated the standard auditor’s report encompassed 2 parts (i.e., the research objectives stated as #3 & 4):</p> <p><u>1st Part:</u> Designed to ascertain financial statement users’ understanding of the messages conveyed by standard unqualified auditors’ reports.</p> <p>This element of the research employed a laboratory study, conducted in the UK and NZ in 2008, to assess whether users’ understanding of the messages conveyed in the auditor’s report is influenced by differences in the format and content of auditors’</p>	<p>For the standard audit report (SAR) to have optimal value it is important that auditors and users have a shared meaning of the responsibilities and limitations of the audit function (“macro” level) and of technical terms used in the report such as “materiality” and “reasonable assurance” (“micro” level).</p> <p>Using a controlled experiment this study examines the congruence of interpretations of auditors, bankers, and investors at both the macro and micro levels.</p> <p>In a field experiment auditors, lenders, and average investors are asked a series of questions concerning their interpretation of seven macro and five micro messages contained in the SAR of a hypothetical company.</p>	<p><u>Experiment.</u></p> <p>We conducted a full-factorial two (complete auditor’s report, opinion only) by three (auditors, financial analysts, students) between-subjects experiment with participants from Germany (GER) and the Netherlands (NL). The research design and the number of participants who completed the survey in the Netherlands and Germany are shown in Table 1. Detailed demographic information about the participants in both countries is provided in additional tables in Part 2 of the Appendix. The experimental case used in these experiments is reproduced in Part 1 of the Appendix.</p> <p>Experienced auditors and users (i.e. financial analysts as sophisticated users</p>

#1 Mock et al.	#2 Porter et al.	#3 Asare & Wright	#4 Gold et al.
<p>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.</p> <p>Focus Groups</p> <p>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.</p> <p>Each category of stakeholders met separately. Each focus group session consisted of three parts with an overall goal of identifying the perceived information quality of the auditor's report.</p> <p>Preliminary areas of discussion were identified as:</p> <ul style="list-style-type: none"> ▪ 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 	<p>reports.</p> <p><u>2nd Part:</u> Sought to establish the changes to auditors' reports that financial statement users (and other interest groups) consider would make the reports more useful.</p> <p>Research conducted by means of open-ended questions posed to the survey respondents and the experiment participants that were designed to ascertain their opinion on the most important items in auditors' reports and the changes they would like made to auditors' reports in order to render them more useful.</p> <p>The survey respondents and experiment subjects were asked to indicate:</p> <ol style="list-style-type: none"> 1. in order of priority, which three elements of an auditor's report they find most useful; 2. information that is currently provided in an auditor's report they would prefer to be omitted; 3. other information they would like to be included in an auditor's report. 	<p>Three hundred auditors currently in public practice were randomly selected from the AICPA membership list and received a letter from the AICPA encouraging their voluntary participation in the project. Seventy-eight auditors responded, representing a 35% response rate (78/225).</p> <p>Contact individuals at various banks were identified by the AICPA to enlist lender participants. Thirty three bankers participated in the study by completion of the case over the internet.</p> <p>The experiment began by providing background information on a hypothetical company based on actual firm in the retail hardware industry. This information described the nature of the business, noted the company had been audited for 27 years, and provided summary financial and non-financial information (e.g., sales, income, total assets, ratios, number of stores). The current unqualified SAR was then provided. The background information was followed by a series of questions that focus on participant interpretation of the SAR with respect to the macro and micro factors.</p> <p>With respect to the macro analysis, we focused on the following areas: (i) importance of SAR in making investment and lending decisions (decision-usefulness) ; (ii) importance of SAR in</p>	<p>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.</p> <p>The experiment was conducted as a web-based survey. Participants received an invitation email that provided a link to the survey. The survey was constructed with the online survey software. The software allowed random distribution of the two experimental treatments (complete audit report versus audit opinion only) between participants. The survey was provided in Dutch and German, depending on the participants' origin.</p> <p>All participants were asked to read a short description of a stock-listed company, followed by summarized financial statement information from the last two years. Following this firm-specific information, all participants were shown the auditor's report on the financial statements. In the "opinion only" condition, participants read the auditor's opinion only, while the "complete audit report" condition disclosed the complete text of the ISA 700 version of the auditor's report (including the opinion). Hence, the difference between the two conditions was</p>

#1 Mock et al.	#2 Porter et al.	#3 Asare & Wright	#4 Gold et al.
<p>misperceptions about the audit process;</p> <ul style="list-style-type: none"> ▪ Other issues that might be inferred from the auditor's report. <p>Verbal Protocol Analysis (VPA)</p> <p>Verbal Protocol Analysis (VPA) was used to examine if and how the unqualified auditor's report impacts the judgments of financial statement users. (The rationale for using the approach is that 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.)</p> <p>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 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.</p> <p>The VPA research consists of two studies. For each study, an experimental task was completed by eight experienced financial analysts with a total of 16 different analysts participating.</p> <p>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. 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.</p>	<p><u>Details of the design of the experiment component of the study</u></p> <p>A behavioural research study using a laboratory/experimental approach to explore participants' responses to four differing audit reports. (Between-subjects design used. Participants were randomly assigned to one of four groups; as a result of this random allocation of participants to the groups, there was no significant difference in the background and experience of the participants in each group.) This allowed for the assessment, under controlled conditions, of the decision impact of four different variations of the audit report.</p> <p>Differences in the content and format of the four audit reports used in the experiments are summarised in Figure 17; it should be noted that all four variants contained an unqualified opinion. Examples of the four audit reports used in the experiments are provided in Appendix D.</p> <p>An indication of the participants' experience with the audit function, financial statements and audit reports is provided in Figures 18, 19a and 19b. These show, respectively, the interest group to which the</p>	<p>assessing that the financial statements are free from material fraud (information risk); (iii) level of confidence that the SAR provides on the company's future viability (viability risk); (iv) level of confidence that the SAR provides on how well the company is managed (governance risk); (v) the level of confidence that the SAR provides that the company is a sound investment (investment soundness risk); (vi) level of confidence that the SAR provides that the company will meet its strategic goals (strategic risk); and (viii) the likelihood the auditors have detected material fraud in the financial statements (fraud detection risk). The last item was elicited on a 101 likelihood scale; all others were on a seven point appropriately labeled scale. (See panel A of Table 1 for response scales used.)</p> <p>With respect to the micro analysis, we focus on the SAR's use of the terms "material misstatements," "reasonable assurance," "test basis," "significant estimates" from the scope paragraph and "present fairly," from the opinion paragraph</p> <p>To investigate these issues, in an experiment 154 participants are provided the standard audit report of a disguised company and asked to respond to 7 questions dealing with the objectives and limitations of the SAR (macro factors) and</p>	<p>to disclose versus not to disclose the first part of the text of the ISA 700 auditor's report, which contains the detailed explanations of the auditor's responsibilities in comparison to management and of the task and scope of the audit.</p> <p>Following the case description, participants were asked to respond to a set of questions related to two different areas:</p> <ol style="list-style-type: none"> (1) the responsibility of the auditor versus management for producing the financial statements, detecting and preventing fraud, the soundness of the firm's internal control structure, etc.; and (2) the reliability of the financial statements with respect to misstatements, fraud, errors, etc.

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<p>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.</p> <p>Each VPA session lasted approximately one hour.</p> <p>In Study 1, the 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.</p> <p>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.</p> <p>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.</p>	<p>participants belong, their interest in financial statements and their interest in audit reports. From these Figures it may be seen that the profile of the participants in the UK and NZ, in terms of their knowledge of, and experience with, financial statements and auditors' reports is broadly similar.</p> <p>For example, 56 per cent of the UK participants, and 54 per cent of those from NZ, indicated that they occasionally or usually read the financial statements they obtain. Similarly, 44 per cent and 48 per cent of the UK and NZ participants, respectively, signified that they occasionally or usually read the auditor's report when they either glance at or read financial statements. (As shown beneath Figures 19a and 19b, the terms 'read' and 'glance at' where defined in the experiment instrument.)</p> <p>It was also ascertained that 42 per cent of the participants from the UK, and 40 per cent of those from NZ, have prior university-level education in accounting. No significant difference was found in the responses based on the demographic background, educational qualifications or experience of the participants.</p>	<p>their understanding of five technical terms used in SAR to convey the audit findings (micro factors).</p> <p>Our primary analysis focuses on between group differences, which we classify as being consistent with one of three patterns: (i) the user groups (investors and lenders) differ from the auditor group (which we define as a "type I gap"); (ii) one user group and the auditor group differ from the other user group ("type II" gap); or (iii) the user groups differ from each other as well as from the auditor group ("type III gap").</p> <p>Arguably, a type I gap is of the greatest concern to standard setters, since it represents a fundamental communication gap between the issuers and users of the SAR and is likely to lead to misinterpretation and potentially litigation. On the other hand, a type II gap potentially represents an opportunistic communication gap, driven by a particular user's context and a type III gap represents a complete absence of shared meaning.</p>	

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	<p><u>Details of the design of the survey component of the study</u></p> <p>The composition, structure and extent of the audit expectation-performance gap in the UK and NZ in 2008 was investigated by means of a mail survey. This facilitated ascertaining the opinions of representative samples of groups in society who are affected to a greater or lesser extent by the audit function, about auditors’ responsibilities and the standard of their performance.</p> <p>Subgroups of each of the broad interest groups identified for the research study (see discussion of Research Participants below) were identified and samples of survey participants randomly selected from the subgroup populations. Questionnaires were mailed to 1,610 named individuals in the UK and to 1,555 named individuals in NZ. Details of the interest groups and their response rates for the UK and NZ are provided in Figure 4ai and 4bi, respectively. From Figure 4ai and 4bi it may be seen that an overall response rate of 14 per cent was achieved in the UK and 29 per cent in NZ.</p>		

C. RESEARCH SUBJECTS USED: PARTICIPANTS IN THE RESEARCH STUDIES

#1 Mock et al.	#2 Porter et al.	#3 Asare & Wright	#4 Gold et al.
<p>Focus Groups</p> <p>A total of 53 individuals participated in the focus groups.</p> <p>Five different categories of stakeholders were invited to participate, including:</p> <ol style="list-style-type: none"> (1) preparers of financial statements that are subsequently audited (the CFOs), (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. <p>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.</p> <p>Verbal Protocol Analysis (VPA)</p> <p>All VPA sessions were conducted in Australia. For each study, an experimental task was completed by eight experienced financial analysts, with a total of 16 different analysts participating. All were experienced and currently-active financial analysts.</p>	<p><u>Experimental component:</u></p> <p>Participants comprised a total of 252 MBA students:</p> <p>125 from four universities in NZ; 127 from three universities in UK.</p> <p><u>Survey component:</u></p> <p><i>Selection of the survey sample</i></p> <p>Four broad interest groups were first identified, each having a distinct and different relationship with auditors and the audit function, namely:</p> <ul style="list-style-type: none"> • external auditors – the performers of external financial statement audits; • auditees – the subjects of external audits; • audit beneficiaries from the financial community – direct beneficiaries of the audit function (as users of audited financial statements); • audit beneficiaries from outside the financial community – indirect beneficiaries of the audit function [for example, as members of pension funds and/or as contributors to insurance companies (through the payment of premiums) and National or Local Government funds (through payment of taxes) which are invested in 	<p>In a field experiment auditors, lenders, and average investors are asked a series of questions concerning their interpretation of seven macro and five micro messages contained in the SAR of a hypothetical company.</p> <p>Three hundred auditors currently in public practice were randomly selected from the AICPA membership list and received a letter from the AICPA encouraging their voluntary participation in the project. Seventy-eight auditors responded, representing a 35% response rate (78/225).</p> <p>Contact individuals at various banks were identified by the AICPA to enlist lender participants. Thirty three bankers participated in the study by completion of the case over the internet.</p> <p>There were 154 participants in the experiment (43 average investors, 78 auditors, and 33 lenders).</p> <p>MBA students from a private university are employed as surrogates for average investors. 43 average investors with a mean (σ) of 5.3 (5.8) years of work experience, were recruited to participate from the Accounting core course in the MBA program.</p> <p>78 auditors currently in public practice.</p>	<p>Participants were:</p> <ol style="list-style-type: none"> 1. Experienced auditors: 205 auditors in Germany from: 1 big4 firm & multiple non-big4 firms 58 auditors in the Netherlands: all participants from 1 big4 firm. 2. Users: <ol style="list-style-type: none"> a. Sophisticated users (represented by financial analysts) 62 financial analysts in Germany; 20 in the Netherlands. b. Unsophisticated users (represented by students) 60 students in Germany; 46 students in the Netherlands <p>(Incentives were provided to encourage participation – varying types.)</p>

#1 Mock et al.	#2 Porter et al.	#3 Asare & Wright	#4 Gold et al.
	<p>companies whose financial statements are subject to audit].</p> <p>Subgroups of each of the broad interest groups were identified and samples of survey participants randomly selected from the subgroup populations.</p> <p>Figures 4aⁱⁱ and 4bⁱⁱ provide, respectively, details of the profiles of the UK and NZ interest groups’ experience with the audit function and their interest in financial statements and audit reports. ... in both the UK and NZ, the auditors and financial community audit beneficiaries read financial statements more frequently than do the auditees and, more particularly, the non-financial community group – although a surprisingly high proportion of the non-financial community group in NZ do so. Similarly, in the UK, the auditor and financial community group read auditors’ report more frequently than do the members of the other two interest groups. However, in NZ, somewhat unexpectedly, the auditees read auditors’ reports more frequently than the financial community group, and 25 per cent of the non-financial community group indicated that they ‘usually’ read audit reports.</p>	<p>These auditors responded to a request from the AICPA encouraging their participation (from 225 randomly selected members from the AICPA membership list who had sufficient information to complete the study). The auditors who responded had a mean (σ) of 12.46 (11.11) years audit experience.</p> <p>33 bankers, with a mean (σ) of 13.8 (11.1) years audit experience, participated in the study.</p>	

D. LIMITATIONS NOTED

#1 Mock et al.	#2 Porter et al.	#3 Asare & Wright	#4 Gold et al.
<p>In this research project, we use primarily qualitative techniques to identify perceptions by and usefulness to various stakeholders of an unqualified auditor's report.</p> <p>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.</p> <p>A key point about focus groups is that they are a form of <i>qualitative</i> 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 <i>generally</i> or <i>most</i> 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.</p>	<p><u>Regarding the experimental component of the study</u></p> <p>While experimental research offers a strong control environment and the ability to create audit report scenarios which are not naturally available, the representativeness of experimental findings is generally limited. The findings of this portion of the research provide evidence of the perceptions of a group of reasonably knowledgeable UK and NZ readers of financial statements but, given the relatively small number of subjects involved (252 participants) and the population from which they were drawn (MBA students), the findings are indicative rather than conclusive evidence of the perceptions of a more general population.</p> <p>Furthermore, null statistical findings such as those reported in Chapter 7 of this report should be treated with caution as they are evidence that the relationships tested are not statistically significant; this does not mean that such relationships do not exist but merely that they are not statistically significant in this context.</p>	<p>Our findings need corroboration in other settings and with a different sample of users. For instance, we obtain the interpretations of average investors. It is important to determine whether more sophisticated investors such as analysts display similar interpretations of the SAR.</p> <p>Our data were also gathered during a recessionary period, and it would be valuable to determine if the results are similar during other, less difficult economic times</p>	<p>This study has some limitations that need to be acknowledged.</p> <p>First, an assumption maintained in this study is that auditors' perceptions of auditor and management responsibilities as well as of (audited) financial statements' reliability can be considered as an indicator of the "true" responsibilities and financial statement reliability. Even though auditors are likely to have self-interests and may also "strategically" respond to questions relating to their own responsibilities, it is plausible to assume that – due to their in-depth knowledge of the audit process with its legal requirements and general possibilities and limitations and due to their extensive experience with financial statements – auditors are the best people available to take as a "benchmark" in this regard. Therefore, this is indeed a maintained assumption in most of the prior empirical research on the audit expectation gap.</p> <p>Second, we have not hypothesized any differences in perceptions related to auditor and management responsibilities as well as to the reliability of financial statements between German and Dutch participants, which is consistent with having no reasons to do so from a theory</p>

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	<p><u>Regarding the survey component of the study</u> Survey research is always accompanied by some inherent limitations, in particular, the questions being open to the respondents' interpretation and the possibility that someone other than the identified respondent completed the questionnaire. Steps were taken to mitigate these limitations by conducting a thorough pilot study of the questionnaire and addressing each questionnaire to a named individual. However, the limitations can never be eliminated.</p> <p>The survey achieved a disappointingly low usable response rate ... [it] was mailed to 1,610 participants in the UK and 1,555 in NZ and usable response rates of 14 per cent and 29 per cent, respectively, were achieved ... As normal, the survey responses were tested for non-response bias and no such bias was found. However, the robustness of the 2008 survey results is tempered to an extent by the low response rates.</p> <p>Nevertheless, despite this cautionary note, the findings of the 2008 survey reflect the continuance of a trend which was evident from the 1989 and 1999 surveys. Similarly, they</p>		<p>perspective, since both countries are neighbors in the western hemisphere and have very similar economic structures. Corresponding with this view, our analyses conducted in this report do not suggest important differences between the two countries. A detailed descriptive summary of our data for the two countries is provided in Part 2 of the Appendix. This includes demographic information about the participants, descriptive data of the three index variables/factors, the individual items, and a number of additional variables not explicitly analyzed in this report, but which may provide useful background information on our findings.</p>

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	confirm the persistence of elements of the expectation gap which have been found by numerous studies in many countries since 1970.		

E. INTERNATIONAL SETTING(S)?

<i>#1 Mock et al.</i>	<i>#2 Porter et al.</i>	<i>#3 Asare & Wright</i>	<i>#4 Gold et al.</i>
Yes; VPA participants from Australia.	Yes; UK and NZ	No	Yes: Germany and Dutch user perceptions examined
US Setting?			
Yes	No	Yes	No

F. REPORTED FINDINGS

(Refer to actual reports – extracts only)

F.1 HIGH-LEVEL FINDINGS

#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.

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.

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.

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).

The VPA Study 1 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)

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).

Key areas where lack of clarity exists among users are:

- ***What is the Intended Message in the Unqualified Auditor's Report?***
Lack of clarity on this issue appears to be a source of confusion revealed by the various focus groups.
- ***What is the Intended Level of Assurance Provided by an Unqualified 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 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.
- ***What Other Information Might Auditors Communicate in Conjunction with an Auditor's Report?***
Findings in both the VPA studies and the focus groups indicate 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 in indicating more information and transparency would be highly desirable.

F. REPORTED FINDINGS

(Refer to actual reports – extracts only)

F.1 HIGH-LEVEL FINDINGS

#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.*

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).

Expanded disclosure of matters found to be important to financial statement users 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, information similar to that required by SASs No. 114 and 115, and ISAs 260 and 315 and specific information about selected audit procedures and judgments suggested by participants in this study.

The following categories of information might be considered for such expanded disclosure (subject to further research):

Information About the Audit—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.

► Materiality

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."

Quality of the Financial Statements

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.

F. REPORTED FINDINGS

(Refer to actual reports – extracts only)

F.1 HIGH-LEVEL FINDINGS

#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.*

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.

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.

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.

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 concern evaluation, while SAS No. 114 and ISA 260 refer to other risks that may be communicated.

► 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 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.

F.1 HIGH-LEVEL FINDINGS

#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. September 2009.

In an attempt to narrow the audit expectation gap, the auditing profession adopted the standard auditor's report as a means of educating financial statement users about the respective responsibilities of the directors and the auditor for the financial statements and about the audit process.

Between 1999 and 2008 essentially the same standard long form audit report was used in both the UK and NZ. However, analysis of the results of the surveys conducted in the UK and NZ in 1999 and 2008 suggests that the educational intent of the standard long form audit report has made little, if any, difference to financial statement users', and other interest groups', understanding of the audit function or auditors' responsibilities.

This conclusion is supported by the findings of the experiment conducted in the UK and NZ in 2008 which was designed to ascertain financial statements users' understanding of the messages contained in a standard unqualified audit report. The experiment found that the content of the auditor's report makes no difference to financial statements users' understanding of the respective responsibilities of the directors and the auditor for the financial statements or the nature of the audit process. It thus seems that few financial statement users derive value from the inclusion of the explanatory paragraphs about these matters in an auditor's report.

As part of the survey and experiment tasks, the respondents were asked to identify the most important items in an auditor's report. The overwhelming majority of the respondents identified the auditor's 'true and fair' opinion as the most important item but a significant proportion also included among the most important items:

- the basis of the auditor's opinion;
- the statement of the directors' and the auditor's responsibilities with respect to the financial statements;
- identification of the audit firm which conducted the audit; and
- types of, and reasons for, audit qualifications,

In the light of:

- (i) the survey finding that the explanatory paragraphs in the auditor's report appear not to have improved the understanding of financial statement users, or that of other societal interest groups, about the audit function or auditors' responsibilities, and
- (ii) the experiment's finding that the content of the auditor's report makes no significant difference to financial statements users' understanding of the respective responsibilities of the directors and the auditor for the financial statements or the nature of the audit process,

The presence of the first two items listed above among the most important elements of an auditor's report is somewhat puzzling. One possible explanation is that, rather than identifying what they believe to be the most important items in an auditor's report, a significant number of the respondents named elements they are aware are present therein.

Given the survey's and experiment's finding that the long form audit report has had little or no success in increasing financial statement users', and other interested parties', understanding of the audit process and auditors' responsibilities, it seems that the auditor's report may not be a useful vehicle for narrowing the audit expectation gap and that other means may be more effective.

F.1 HIGH-LEVEL FINDINGS

#3 Investors', Auditors' and Lenders' Understanding of the Message Conveyed By the Standard Audit Report. September 2009.

Results indicate that the current SAR results in important type I macro communication gaps, which is evidence that in spite of the enhanced scope paragraph in SAS 58, the objectives and limitations of the SAR are not well understood or alternatively users and issuers have little shared meaning. 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 additional clarifications may be needed.

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.

#4 Financial Statement Users' Perceptions of the IAASB's ISA 700 Unqualified Auditor's Report in Germany and the Netherlands. August 2009

This study provides insight into financial statement users' perceptions regarding auditor and management responsibilities as well as financial statement reliability to investigate a possible reduction of the expectation gap under the revised ISA 700 auditor's report.

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.

F. REPORTED FINDINGS

(Refer to actual research reports – extracts only)

F.2 DETAILED FINDINGS

#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.*

Focus Groups

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.

Level of Assurance

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.

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 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.

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.

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.

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.

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.

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.

Overall Usefulness of Unqualified Auditor's Report

It is important to note that these comments [below] 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.

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.

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.

B. Verbal Protocol Analysis (VPA)

VPA Study 1.

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.

It 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.

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. 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 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. 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*. 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.

#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. September 2009.

Regarding Research Objectives #3 & 4 (research investigating the standard auditor's report)

Results of 1st Part (Research Objective #3)

The key finding of this research is that, notwithstanding that the experiment subjects were provided with four different variants of unqualified auditors' reports, they perceived no differences in the messages conveyed by the reports. This seems to support the conclusion reached as an outcome of studies which have investigated the audit expectation gap since the long form audit report has been in general use (since the early 1990s), namely, that the educational material provided in the standard long form audit report has had little, if any, impact on financial statement users' (and other societal interest groups') understanding of the audit function and auditors' responsibilities.

Results of 2nd Part (Research Objective #4):

... the item in auditors' reports identified as the most important is that of the auditor's 'true and fair' opinion. Other items considered by a significant number of respondents to be amongst the most important in an auditor's report are:

- the basis for the auditor's opinion;
- the statement of the directors' and the auditor's responsibilities with respect to the financial statements;
- identification of the audit firm which conducted the audit;
- types of, and reasons for, audit qualifications.

Regarding the items the respondents would like to be omitted from an auditor's report, the largest number indicated they would like nothing of that currently provided to be omitted. However, the next most frequently expressed opinion was that everything other than the auditor's opinion on the financial statements should be removed. Along similar lines, some of the respondents signified they would like no additional information to be provided in auditors' report but a significant number indicated they would like statements to be included about: (i) the effectiveness of the auditee's internal controls, non-compliance with key controls and the internal audit function, and (ii) the auditee's culture, the effectiveness of its governance structure and an assessment of management's capability/adequacy.

Some results reported from the survey component of the study (regarding research objectives #1&2)

The survey examined the interest groups' responses to the following questions:

- Is the suggested responsibility an existing responsibility of auditors?
- If so, how well is the responsibility performed?
- Should the responsibility be a responsibility of auditors?

The reported results show that the opinions of the interest groups in the UK and NZ are broadly similar. All of the interest groups display a lack of knowledge of auditors' existing responsibilities, are critical of auditors' performance of some of their existing responsibilities and expect auditors to perform

	<p>responsibilities that extend beyond those they are currently required to perform by statute, case law, regulations and professional promulgations. Further, as might be expected, the more distant an interest group is from the audit function, the less knowledgeable the group is about auditors' existing responsibilities and the broader the responsibilities the group considers auditors should perform.</p> <p>The research also reports on audit expectation-performance gap in NZ between 1989 and 2008, and in the UK between 1999 and 2008.</p> <p>It was noted that between 1999 and 2008 the audit expectation-performance gap narrowed in the UK by nearly 33 per cent, largely as a result of a reduction in UK society's unreasonable expectations of auditors, complemented by society's perception of improved performance by auditors. However, in NZ over the same period, the audit expectation performance gap broadened slightly but, more significantly, society's unreasonable expectations of auditors increased and its perception of the standard of auditors' performance remained virtually unchanged.</p>
Additional matters reported	<p>It was also noted that ...survey and experiment participants who identified additional items they want included in audit reports, clearly signalled that they want auditors to report, in their audit reports, more of the company specific information they routinely report to the company's directors or audit committee. Responding to an invitation in the questionnaire to do so, some of the survey respondents provided additional comments on the auditor's report.</p> <p>These correspond closely with opinions expressed to, and reported by, the AQF Working Group (AQF 2007), namely, auditors' reports:</p> <ul style="list-style-type: none"> • are too formulaic and rather bland, • do not give the impression that the company's financial statements have been critically examined, • need to be expressed more simply and clearly so that they may be more readily understood, • should commence with the auditor's opinion, and • should not contain statements of the directors' and auditors' responsibilities and a description of the audit process – this material should be moved elsewhere where it may be accessed by those who wish to do so. <p>All of these matters provide guidance on the way in which auditors' reports could be made more useful to financial statement users and other interested parties.</p>

#3 Investors', Auditors' and Lenders' Understanding of the Message Conveyed By the Standard Audit Report. September 2009.

Overall (i.e., a pooled analysis) participants rate the SAR as important in investing and lending decisions as well as for assessing whether financial statements are free from material fraud. Further, the SAR provides a high level of confidence that the company will remain viable. On the other hand, the SAR provides a relatively lower level of confidence that the company is well managed, is a sound investment, or that the company will meet its strategic goals. Thus, the assessed overall decision usefulness of SAR appears to be driven by its use in assessing information and viability risks but not governance, investment soundness or strategic risks

With respect to between group differences in the understanding of the macro factors, we found a type I gap (i.e., the user groups differ from the auditors) in five of the seven areas. Specifically, users consider the SAR to be relatively more important in assessing that the financial statements are free from material fraud. The same pattern of results hold for the level of confidence that SAR evokes about company management, investment soundness of the company, whether the company is likely to meet its strategic goals, and the likelihood that auditors have detected any 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%.

We found a type II gap for SAR's decision usefulness and its role in assessing viability. On these two macro factors, auditors and bankers had the same shared meaning but differed from investors. Investors find SAR to be of higher importance for making decisions than auditors and bankers but the investors also have relatively lower confidence that the presence of SAR will assure viability of the company.

Further, there were prevalent differences in the meaning attached to many of the micro level technical terms studied. For instance, we found type III gaps in the interpretation of "test basis." This represents widespread differences and suggest those terms should be clarified, perhaps specifically in the audit report rather than issuing a clarifying standard (e.g., SAS 69). However, most micro level differences were of the type II category, suggesting the need for a more targeted education of particular user groups rather than change in standards. The one type I gap related to the percent of net income that auditor should use for materiality. Users had a much higher percentage suggesting potential misunderstanding of the effect of materiality on audit effort.

Finally, focusing on the between group differences in the interpretation of technical terms (micro analysis), we found one type I gap (auditors had relatively lower percent of net income than the users for materiality), six type II gaps with no clear patterns, and one type III gaps. The preponderance of the type II gaps suggests that the communication gap could be more opportunistic rather than fundamental. Nevertheless, more precise language may reduce the incidence and opportunities for such opportunistic interpretation.

#4 *Financial Statement Users' Perceptions of the IAASB's ISA 700 Unqualified Auditor's Report in Germany and the Netherlands. August 2009*

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.

Consistent with our predictions, we find that financial statement users ascribe greater (lower) responsibility for the financial statements to auditors (management) as compared to auditors. As for the responsibility ascription to management, we find the gap between students and auditors to be significantly greater as compared to the gap between financial analysts and auditors. Further, students perceive financial statements to be more reliable than auditors do. This gap is significantly greater than the gap between financial analysts and auditors. Overall, our results indicate the persistence of an audit expectation gap based on the revised version of ISA 700 with its new wording for the auditor's report.

We further investigate the importance of the information provided in the ISA 700 audit report by comparing user perceptions based on the complete long-form versus a short-form opinion-only audit report. This allows us to test whether being presented with the detailed explanations of the auditor's responsibilities in comparison to management and the task and scope of the audit leads to an alignment of users' perceptions toward those of auditors.

Contrary to [our] prediction and contrary to the goal of the revised ISA 700 auditor's report, we do not find a reduction in the expectation gap related to ascribed auditor and management responsibilities between auditors and financial statement users when the complete audit report is provided as compared to when the short-form version is provided. This is a robust finding that holds for various sensitivity tests and occurs with a successful experimental manipulation as indicated by the corresponding manipulation check.

While the fact that an audit expectation gap still exists under the new ISA 700 auditor's report is in line with our prediction, it is surprising and somewhat disturbing that the detailed explanations of auditor versus management responsibilities and of the task and scope of the audit seem to be without any effect at all regarding ascribed responsibilities. It is theoretically possible that participants had already "internalized" all the information that is contained in the complete ISA 700 auditor's report before

participating in this study. However, this is plausible only for auditors and to some extent for sophisticated users such as the financial analysts in our study, but not for the entire population of unsophisticated users (students), who had no formal education in auditing.

Thus, it seems that the detailed explanations given in the complete auditor's report are interpreted in a significantly different fashion by users versus auditors. Since auditor and management responsibility ascriptions are virtually identical with and without being presented the detailed explanations of the ISA 700 auditor's report, auditors versus users seem to interpret them in a consistent fashion with their already held beliefs.

As for the reliability ascription, we find the expectation gap to be even increased when the complete audit report is provided. As suggested by additional analyses, this effect is driven by the students rather than the financial analysts. A possible explanation for this counterintuitive finding might be the low experience of students with the issue of financial statement reliability (which very likely is lower than that of financial analysts). Students therefore might be highly uncertain about how much reliability can be ascribed to audited financial statements in a situation where no relevant information on this issue is provided (as is the case in the opinion only condition). Therefore, they might make a particularly "prudent" assessment in this condition (at least from *their* point of view). In contrast, when provided with relevant cues relating to the reliability of audited financial statements (as contained in the complete auditor's report), they may feel better informed. This reduction in uncertainty might make them "dare" to make a less cautious assessment, particularly if they get the impression that there are two parties (management and the auditor) who both take over certain responsibilities with regard to financial statement reliability, and which may appear "more" than what they originally had in mind without this explicit information.

Taken together, these results indicate that the comprehensive explanations of auditor vs. management responsibilities and of the task and scope of the audit in the new ISA 700 auditor's report are not effective in reducing the audit expectation gap and in part can even have a detrimental effect. The results suggest that both auditors and users interpret these explanations in a significantly different fashion and possibly "simply" consistent with their preconceptions. This might indicate that the explanations need to be formulated stronger, better understandable (particularly to users), and perhaps less ambiguous, i.e. leaving less room for individual interpretation. However, at this stage, this is speculative and needs further research to shed light on.