

Mr. James Gunn,
Technical Director
International Auditing and Assurance Standards Board (IAASB)
New York, NY
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October 15, 2012

Re: IAASB's Invitation to Comment on Improving the Auditors Report.

Dear Mr. Gunn,

We appreciate the opportunity to respond to the IAASB's Invitation to Comment on Improving the Auditors Report. We are Professors of Accounting in Canada (Karim Jamal is CA Chair Professor at University of Alberta) and the US (Shyam Sunder is James Frank Professor at Yale University) and are interested in seeing improvement in quality of audits. In addition to responding to some of the questions posed by the IAASB, we provide a background paper which more fully discusses our reasoned perspective on audit of financial reporting. Our specific responses are given below.

Q1: Overall do you believe the IAASB's suggested improvements sufficiently enhance the informational value of the auditors' report?

No. We don't believe that these suggestions will improve audit reporting. We currently have an audit report where the auditor provides 3 paragraphs of boilerplate / legal disclaimers that communicate little of value to users. We are concerned that the proposed audit report will generate a much larger (4 pages or more) audit report filled with boilerplate and legal disclaimers and further reduce the chances that the users would read or be informed by them. These proposals seem to be driven, not by the motivation to better inform the users, but by the hope of better legal defense in case of audit failures. We do not think the auditors will be in a better position to defend themselves with the 4+ pages of report.

Q2: Are there other alternatives that should be considered by IAASB?

We propose that auditors should be required to grade the financial reports of a company on an A-F scale. The auditor should provide one overall grade for quality of financial reporting, and four sub-grades for features of the financial statements and systems, such as the quality of an organization's internal control system, governance, propriety of accounting policies and quality of disclosure. Then the considerable knowledge gained by the auditor would provide benefit to the audit committee and to users of financial statements. Both the original grade as well as the final grade after the adjustments in response to audit letter should be published for the public.

Q3: Do you believe the concept of auditor commentary is an appropriate response?

No. As we discuss in our background paper, this approach of auditor commentary takes us back in time. Before the regulation of the audit profession, auditors issued “long form” audit reports that provided commentary of this type. While this worked at one point in the past, the profession moved away from this approach and we feel that commercialization of auditing and changes in incentives of auditors are so dramatic as to make it untenable for the profession to trace back its steps. Under these proposals, auditor commentary will be just as idiosyncratic and non-comparable as before, and will only furnish more verbose boilerplate statements and legal disclaimers.

Q8: What are your views on the value and impediments of suggested auditor statements relating to going concern?

We are firmly opposed to having auditors provide opinions about going concern. This is outside the expertise of the auditor, encroaches on managements reporting responsibilities and has the potential to create a bad self-fulfilling prophecy whereby an audit opinion can cause an entity to collapse and cease to be a going concern.

We are disappointed at auditing regulators resurrecting bad policy proposals on an ongoing basis. Periodic resurrection of proposals for audit firm rotation, and enhancing auditor reporting on going concern are two good examples. These two “zombie” type proposals never seem to die. These proposals are so wrong-headed that they cast doubt on the credibility of audit regulators.

We would be happy to discuss issues with you in more detail and can be reached at Karim Jamal kjamal@ualberta.ca (780 492 5829) and Shyam Sunder shyam.sunder@yale.edu (203 432 6160).

Auditor Reporting Background Paper

Karim Jamal and Shyam Sunder

October 15, 2012

Regulatory attempts to improve the functioning of capital markets often try to make corporate activities more transparent. The International Auditing and Assurance Standards Board (IAASB) invited comments on its proposals contained in “Improving the Auditors Report,” with an exposure draft expected to be issued by June 2013. These proposals are intended to make the audit report more useful, and to better communicate the role of the auditor. Auditors’ boilerplate, essentially pass/fail, reports to the public reveal little of the fine-grained understanding auditors gain about the inner workings about items such as internal controls, accounting policies, disclosure, and governance of their clients beyond the name of the auditor and the date of the audit report.

The IAASB proposes to improve the current three-paragraph audit report by switching to a four page report by incorporating two additional elements: an opinion about management’s use of the going concern assumption, and an “Auditor Commentary.” The commentary should help users better understand the audited financial statements and or the audit. A sample report in the proposal includes comments on litigation, goodwill, financial instruments, audit strategy for verifying revenue, receivables and cash receipts, the entity’s internal controls over these items, involvement of other auditors, responsibilities of management, and responsibilities of the auditor.

Some auditing regulatory ideas, no matter how bad, seem to be resurrected periodically in spite of repeated burials. Auditor opinion on the going concern and financial viability of a company and mandatory audit firm rotation are two such zombies. The going concern assumption already undergirds a clean audit report, which cannot be issued if the auditor has any doubts. Beyond that, the auditor has no special insight on the future viability of a company. Requiring further opinion from auditors will either induce them to wait until doubts about the continued viability of the firm are common knowledge, or issue advance warning about such doubts. The former is worthless because the horse would have escaped the proverbial barn by then, and the latter will likely prove to be a self-fulfilling prophecy, and cause the company to fail. Either way, this part of the proposal does little to improve auditing or audit reports.

The major substantive proposal for an “Auditor Commentary” will revive the early practice of an oral detailed report (hence the term “auditor”), subsequently changed to writing. Before being regulated under the U.S. securities laws of 1932 and 1933, audit firms issued either a “short form” or a “long form” audit report. Short form reports could be a single word (e.g., Certified) or one sentence (I Certify the above statement is correct – see Himmelblau 1927¹). Long form audit reports provided more nuanced and informative commentary about the procedures performed, and valuation judgments made, by the auditor. For example, the 1902 Price Waterhouse audit report for U.S. Steel commented on policies on fixed asset capitalization, depreciation, inventory valuation, revenue recognition, and described in detail audit procedures conducted to verify cash

¹ Himmelblau, David. 1927. *Auditors’ Certificates*. New York: The Ronald press Co.

(see Vangermeersch1986²). IAASB's sample audit report resembles this early PW report by including auditor comments on appropriateness of accounting policies, subjectivity inherent in applying these policies, internal control, and description of audit procedures conducted to verify accounts pertaining to key risk areas.

In an unregulated audit market, investors and directors could actually learn something useful by reading an audit report. However, as auditing got regulated, audit reports buried the important and newsworthy inside the boilerplate reports full of disclaimers dictated by lawyers. It is good news if, through this proposal, the regulators are trying to recapture the detail and richness of audit reports that prevailed before the advent of regulation. Whether this effort will succeed depends on the ability of regulators in controlling the risk that the long "auditor commentary" simply furnishes more pages of boilerplate fine print to bury salient issues that deserve attention. An understanding of why this shift in reporting from informative to boilerplate (pass/fail) reports occurred may help avert this outcome.

One possibility is that introduction of audit regulation replaced value-to-customer by a compliance attitude in the audit profession. Studies by Jamal and Sunder – henceforth JS (2011a³,b⁴) of certification reports shows that government agencies tend to issue pass/fail certification reports (for everything from elevators to restaurant cleanliness) whereas private sector certification agencies such as Consumer Reports tend to offer more finely graded reports on 5, 10, or even 100-point scales, sometimes with subgrades for specific features of the product or serve (e.g., value, comfort, gas mileage, safety, and maintainability of a car). Introduction of regulation of auditing plausibly switched the practice towards compliance mentality to start issuing pass/fail boilerplate reports.

Can regulators shift audit reports from government to private sector type? Existing precedents suggest that it is achievable. For example, in a recent experiment, the State of California changed its pass/fail system for grading restaurant hygiene to an A-B-C-F system, and the grade had to be posted for all customers to see. Jin and Leslie⁵ ([2003]) found that this change, with no change in inspection policies, led to significant changes in restaurants sales, as well as in food-related illnesses and doctor visits. It appears that the use of a finer grading system helped improve the inspection process, restaurant hygiene, consumer discrimination, and public health.

Whether similar gains can be achieved in auditing depends on IAASB's attitude and care in designing and directing the new system towards better service instead of just compliance. Our reading of the current proposal is that in its current form, it still represents a compliance mentality, and will therefore make audit reports less, not more useful. If this proposal were implemented in California, instead of a big A or C, the diner

² Vangermeersch, Richard. 1986. *Financial Reporting Milestones in the Annual Reports of United States Steel Corporation*. New York: Gardland Publishing.

³ Jamal, K. and S. Sunder. 2011a. Is mandated independence necessary for audit quality? *Accounting, Organizations & Society*, May/July (36) 4-5: 284-292.

⁴ Jamal, K. and S. Sunder 2011b. Unregulated markets for audit services. *The Japanese Accounting Review*, Vol (1):1-16..

⁵ Jin, G., and PI Leslie. 2003. The Effects of Information on Product Quality: Evidence From Restaurant Hygiene Grade Cards. *Quarterly Journal of Economics*, 118(2), May, 409-451.

will be offered the opportunity to read four pages of framed fine print hung in restaurant lobbies.

A second possibility is that the evolution of the audit report occurred due to shifts in the incentive structure of audit firms, such as the rise of litigation. If this is the driving force behind creating boilerplate audit reports, then it is unlikely that regulators can turn back the clock and go back to the past. Requiring audit firms to provide an “Auditor Commentary” will just produce a 4 page boilerplate report instead of a 3 paragraph boilerplate report in the hope that four pages will furnish better defensive shield against plaintiff’s lawyers. However, if the past experience is any guide, replacing 200 by a 1,000 word report will just as likely provide additional ammunition to those lawyers, no matter how carefully these words are drafted.

A Private Sector Approach to Audit Reporting

As audit regulators like IAASB have moved to harmonize practices across the globe, it has become increasingly fruitless to learn about and identify better audit practices through international comparisons. However, we can still draw some inferences about alternative reporting practices by looking outside accounting and auditing in the economy. What would (or should) audit reports be like if there was a completely unregulated market? Dubey and Geanakoplos⁶ ([2010] – henceforth DG) benchmark model for an optimal grading (reporting) system suggests three properties: (1) *An intermediate number of reporting grades* (5 or 10 possible grades). This reporting scale is informative and motivates agent (organizations) to work hard to improve their grade. A pass/fail report is sub-optimal since it is uninformative and doesn’t motivate agents to work harder, and too many grades (e.g., 100) introduce more measurement error. (2) *A small elite*. (Making it hard to get an A so only exceptional performers get an A), increasing the incentive for improvement, and (3) *An absolute grading scale*. Grading should be done on an absolute scale (score > 90 = A) and not on a curve. An absolute scale gives all agents an incentive to exert effort to improve their grade.

JS (2011a,b) examined the availability of standards and certification for 817 goods and services in the economy. Private sector certification is characterized by some use of pass/fail standards (e.g., Underwriters Laboratory seals on electrical appliances), but more frequent use of 5, 10, and even 100-point scales for a wide variety of goods and services. It is common to have different experts (e.g., wine raters) trying to differentiate themselves from competitors in part by adopting a different reporting scale. JS [2001a,b]) also show that new entrants in a baseball card rating market try to differentiate their certification service by increasing the number of grades in their reporting system, provide elite grades that are hard to get, and don’t grade on a curve.

The norm in private certification markets is to have a choice among certification agencies who have their own proprietary standards, and who use different sets of reporting scales (e.g., Truste Vs BBB Online and WebTrust for e-commerce privacy seals – see Jamal, Maier and Sunder [2003⁷; 2005⁸]). The equivalent in financial reporting

⁶ Dubey, P., and J. Geanakoplos. 2010. Grading exams: 100, 99, 98,...A,B,C? *Games and Economic Behavior*, 69: 72-94.

⁷ Jamal, K. M. Maier and S. Sunder. 2003. Privacy in E-Commerce: Development of Reporting Standards, Disclosure and Assurance Services in an Unregulated Market. (2003). *Journal of Accounting Research*, May. Vol 41 (2): 285-309.

would be for each of the Big-four audit firms to create their own differentiated audit reports. It is also common for private certifiers to provide more transparency by issuing sub-grades and explaining how the overall grade is determined. For example, Consumers Reports rates cars on a 100 point scale, but also provides a set of sub-grades for acceleration, accident avoidance, comfort and convenience, and fuel economy. In the baseball card certification market, Beckett Grading Service (BGS) provides an overall score as well as sub-grades for centering, corners, edges and surfaces. An equivalent audit report would provide an overall grade for quality of financial reporting, and sub-grades for features of the financial statements and systems, such as the quality of an organization's internal control system, governance, propriety of accounting policies and quality of disclosure.

Audit firms could be allowed to volunteer to provide a supplementary report to their client audit committees and thereby provide greater value from the audit. An alternative arrangement would be to create an elite reporting group of companies who agree to meet a higher standard of internal control, governance, accounting quality and disclosure (e.g., AAA-graded beef, although other grades are also fit for human consumption). The auditor's "seal" issued to these companies could then be communicated to users of financial statements.

The current audit report does not help realize and deliver the value potential of auditing for society. While an "Auditor Commentary" has potential to be useful, it also has the risk of becoming simply more mindless and useless verbiage under which the real news gets buried. We hope the audit profession will voluntarily rise to the occasion and develop more informative audit reports to increase the value of auditing to society. More freedom to auditors and their clients in demanding and devising audit reports may encourage evolution towards that goal.

⁸ Jamal, K. M. Maier and S. Sunder. 2005. Enforced Standards Versus Evolution by General Acceptance: A Comparative Study of E-Commerce Privacy Disclosure and Practice in The US and UK. *Journal of Accounting Research*, Vol 43 (1), March: 73-96.