
**Comment letter to respond to the IAASB invitation to comment on its
Exposure Draft, *Reporting on Audited Financial Statements: Proposed
New and Revised International Standards on Auditing (ISAs)***

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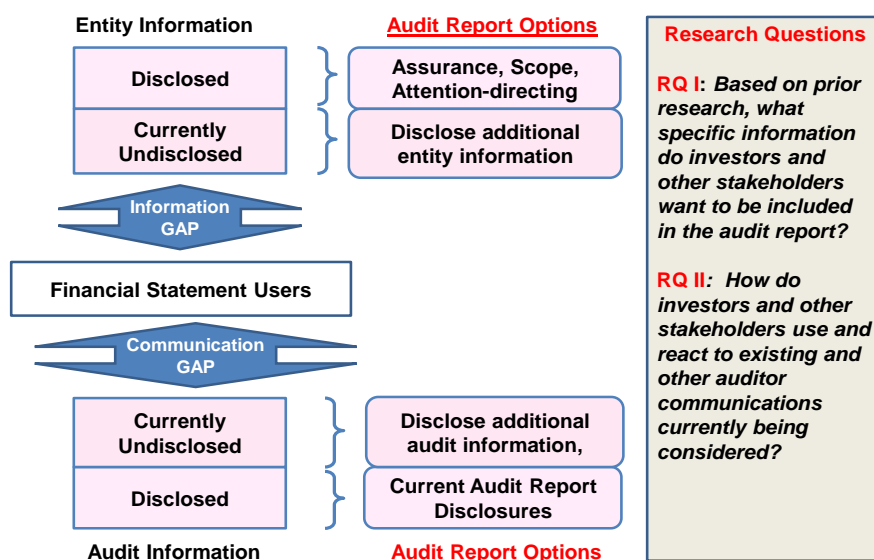
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*Note: This comment letter is based partly on a synthesis of the literature on the audit reporting model (Mock, Bédard, Coram, Davis, Espahbodi and Warne. 2013). Although this comment letter is written by a subset of the synthesis authors, it expresses the views of the authors and does not reflect an official position of the American Accounting Association, the Auditing Section of the AAA or any other organization.

INTRODUCTION AND COMMENT OBJECTIVES

1. The International Auditing and Assurance Standards Board (IAASB) has invited comments concerning its Exposure Draft, *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing* (ISAs) (IAASB 2013). The proposed ISAs calls for:
 - A new section in the audit report describing the matters the auditor determined to be of most significance in the audit
 - A new section in the audit report making explicit the auditor's conclusions on the appropriateness of management's use of the going concern basis of accounting and on material uncertainties
 - An explicit statement regarding the auditor's independence and the sources of the independence requirements
 - Auditor's conclusion regarding the outcome of auditor's responsibilities with respect to 'other information' in the annual report
 - Identification of the engagement partner's name.
2. These proposed changes are the IAASB' response to users, regulators and audit oversight bodies' desire for increased transparency about the audit. In the exposure draft, the IAASB lists several benefits and other effects of the proposed standards where prior audit research may be consulted to assess their likelihood of being realized including:
 - Enhanced communicative value of the auditor's report, providing more transparency about the audit that was performed.
 - Renewed focus of the auditor on matters to be reported, which could indirectly result in an increase in professional skepticism, among other contributors to audit quality.
3. The proposed standards include the disclosure of additional information highlighting matters important to users' understanding of audited financial statements or the audit, information which may help close the information and communication gaps depicted in Figure 1 below. In this comment letter, we augment our synthesis of academic research (Mock et al. 2013) by:
 - Providing an updated synthesis of research including relevant newly published research studies,
 - Indicating to what extent we believe prior research suggests that particular opportunities to close these gaps are likely to be realized, and
 - Indicate the amount of prior research evidence that is available and areas where little or no prior research is available and areas where opportunities for future research exist.
4. Mock et al. (2013) provide a framework based on communication theory to illustrate the basic options concerning the content of the audit report (see Figure 1). They separate the expectation gap into two components: the information gap, which relate to information about the entity, and communication gap, which relate to information about the audit.

Figure 1: Information Gap, Communication Gap, Audit Report Options and Research Questions



5. In this comment to the IAASB exposure draft, we first provide a review of additional research that has been published and indicate whether their findings support or weaken the synthesis findings in Mock et al. (2013). Second, based on the reviewed research literature, we evaluate the extent to which the proposed disclosures in the IAASB exposure draft are expected to close the 'gaps' identified in Mock et al. (2013) synthesis. Finally, based on our analysis, we identify some opportunities that could produce useful information for standard setters.

NEW RESEARCH FINDINGS WITH RESPECT TO THE NEED FOR AND USE OF AUDITOR COMMUNICATIONS

6. The Mock et al. (2013) synthesis built on a previous research review developed by Church et al. (2008) and synthesized approximately 90 studies published between 2007 and 2011. To prepare this section we considered an additional 30 research studies published after their review, and reflected on whether the prior synthesis findings are supported [strengthened] or possibly weakened. As many of these studies relate to settings or issues that are not directly related to topics included in the IAASB exposure draft, they are not considered directly to prepare this comment.

RQ 1- Users information needs

7. In their synthesis of prior research with respect to the specific information investors and other stakeholders want included in the audit report, Mock et al. (2013, 331) concluded that “stakeholders deem the audit report as important, but they desire more information about the auditor, the audit, and the financial statements including MD&A. Audit related information desired include auditor independence, audit process, materiality, level of assurance the auditor is providing, and entity-related information including accounting policies and risk-related information” There are two main recent studies that have examined the information desired by financial statement users.
8. Carcello (2012) conducted a survey of over 300 diverse knowledgeable, financial statement users. The results indicate that 91% of participants did not read the standard audit report (SAR), and 18% reported that the auditor’s report is useless. Participants also expressed a desire for more information from the auditor. For example, 79% of survey participants desired greater disclosures regarding management’s significant judgments and estimates. Also, 77% wanted more auditor disclosures related to risk. Overall, the results indicate that a sizeable majority of experienced financial statement users desire more disclosures from the auditor.
9. Vanstraelen et al. (2012) conducted semi-structured interviews lasting 30-60 minutes each with a small number of auditors and professional financial statement users to assess the information gap associated with the auditor’s report. Results indicate that neither auditors nor financial statement users want the auditor to release engagement statistics or information about the audit process. However, financial statement users state a desire for more information related to the entity’s risk and internal controls. Furthermore, they express a desire for the auditor to an “evaluation of accounting policies and practices, critical accounting estimates, and accounting judgments” (p. 207). Based on the findings of their research, the authors propose an auditor reporting model that consists of the following elements:
 - Audit scope. Include a listing of items that are part of the audit. Additional educational material could be linked to a website.
 - Audit findings. Unequivocal conclusions on each part of the audit.
 - Auditor discussion and analysis. Discussion and analysis of the auditor’s findings of each part of the audit.
 - Information about the auditor. To assist users to evaluated audit quality. This could be a reference to the audit firm’s transparency report.
10. Overall, the findings from these two studies are broadly consistent with Mock et al. (2013). That is, users want more information about the auditor, audit and financial statements. However, one difference was noted by Vanstraelen et al. (2012) that more information about the audit process was not particularly important to either group they studied.

RQ 2 - How do investors and other stakeholders use and react to existing and other auditor communications currently being proposed?

11. Many prior studies have investigated the above research question using archival, survey, interview, focus group, and verbal protocol methods. We categorize research into four areas that we use to present our summary of research findings.

Impacts of information currently included in a standard public company audit reports

12. Prior research reviewed by Mock et al. (2013) “suggests that the wording differences implemented in the late 1980s to better explain auditors’ and managers’ responsibilities were noticed by investors. However, the changes do not seem to improve the communicative value of the audit report in other dimensions, particularly in the areas that comprise the audit expectation gap. In fact, the evidence suggests that these changes exacerbate the expectation gap in certain areas. Based on research results, the changes which created the long form report in ISA 700 also do not seem to have improved communicative value of the audit report.”
13. We identified an article (Gold et al. 2012) published since the Mock et al. Synthesis which generally supports the synthesis conclusions. Indeed, in their study of the effect of the new ISA 700 auditor’s report on German auditors and financial statement users, Gold et al. (2012, 287) conclude that it is “disconcerting that the rather detailed explanations of auditor versus management responsibilities do not favourably affect the gap. This observation may indicate that the explanations would need to be formulated more explicitly and clearly, or even that users’ perceptions are simply not malleable by additional information and explanations in the auditor’s report.”

The impact of information included in other types of assurance reports

14. Previous research reviewed by Mock et al. (2013) focused mainly on going concern modification, internal control reporting under SOX 404 and assurance reports on sustainability. Based on their review they conclude that “with regard to market reaction to the auditor report, the research generally finds that disclosure of going-concern modifications does not appear to have information content to users once the underlying information is disclosed in the notes to the financial statements, but the that internal control reporting is useful and value relevant to the market. The studies on assurance reports of other information, such as assurance on sustainability, also indicate that such assurance provides value.”
15. We identified 15 articles concerning the going concern assumption published since the Mock et al. synthesis directly relevant to the exposure draft. Regarding possible auditor communications, we identified seven articles. Whereas many of these studies relate to the decision to include an emphasis of matter paragraph in the auditor report, three are related to the impacts of going concern information. For US public companies, Kaplan and Williams (2013) examine whether issuing a going concern report to financially stressed clients

protects auditors from litigation. They find that for financially stressed clients, going concern reports significantly deter investors from suing auditors and reduces the likelihood of paying a financial settlement in excess of US \$2 million. Using a large sample of Finnish private SMEs, Niemi and Sundgren (2012) find no association between modified audit reports and an increased usage of trade credit relative to bank debt, which they regard as a proxy for credit rationing. They explain their results by the possibility that lenders may rely more on other sources of information for financially stressed SMEs, thereby reducing the weight of modified audit reports. This study supports the Mock et al. (2013) conclusion, that unless, “new” information is provided in the audit report, a going concern audit report does not appear to have information content. However, Kaplan and Williams (2013) suggest that such a report may have value for the auditors by reducing their expected liability loss. As are previous archival studies, these studies are a joint test of the auditor report and financial statement disclosure. Thus, these studies test whether going concern disclosures have value, not whether a going concern audit report has incremental informational value over a financial statements disclosure.

16. Out of the eight articles we identified on internal control reporting, four are relevant for this comment. Two archival studies and an experimental study, confirm the previous conclusion that internal control reporting is useful and relevant. For example, using a sample of US firms subjected to Section 404 of the Sarbanes-Oxley Act, Chen et al. (2012) find that annual earnings are more informative when an auditor provides the first-time internal control audit report along with the financial statement audit report, than when the auditor issues a financial statement audit report alone. Goh et al. (2013) examine the impact of the internal control opinion on auditors’ decision to issue a going concern opinion. Using a sample of financially stressed subjected to Section 404 of the Sarbanes-Oxley Act, they find that the probability of issuing a going concern audit opinion is higher when the auditor issues an adverse internal control opinion. The authors suggest that such behaviour may be caused by the negative impact on future financing of the disclosure of a material weakness in the audit report, which increases the uncertainty as to the ability of the company to continue as a going concern. Using an experimental approach, where by randomly assigning the subjects to the various experimental conditions they can control for other factors, Asare and Wright (2012a) confirm the evidence from archival research that internal control audit reports are informative. Using a sample of analysis and “average” investors they find that users’ confidence in the audit report on the financial statements is lower in the presence of an entity-level material weakness compared to an account-specific material weakness, and that when a material weakness is disclosed in the audit report, confidence assessments are lower than the confidence assessments associated with unqualified internal control reports.
17. Finally, a study on the language used in the auditor report on internal control in the US highlights the possibility that new auditor communications may be subject to a communication gap; that is user interpretations may be different from that intended by standard setters. In this research Asare and Wright (2012b) examine the impact of the

change in terminology between Auditing Standard No. 5 and Auditing Standards No. 2 and find “that equity analysts interpret the term “more than remote” as significantly less likely than a “reasonable possibility”, even though as a definitional matter the two terms describe the same threshold.” (Asare and Wright 2012b, 3).

The effects of auditor’s association with MD&A or other information outside the financial statements

18. In their synthesis, Mock et al. (2013) concluded that there were limitations in the information currently disclosed in MD&A and that the provision of assurance on MD&A presentations, at least on the verifiable components such as financial information and key resources and risks, was perceived to be value relevant. They did not find any study that examined the value of auditing MD&A, but studies on assurance reports on sustainability indicate that such assurance provides value. In our review of recent auditing articles, we did not find any research on the effects of auditor’s association with information outside of the financial statements.

Additional auditor report content and clarification

19. In their synthesis, Mock et al. (2013) reviewed the literature regarding whether the auditor could provide additional information in the audit report through commentaries and the engagement partner signing the audit report. Regarding the first item, they found no research study published in an academic journal. For the partner signature, results from the few studies that examined the relation between auditor signing and audit quality were mixed.
20. In our review of recent auditing articles, we did not find any research on the disclosure of additional information in the audit report. Regarding the audit partner signature, a recent article by Carcello and Li (2013) examine the impact of the introduction in 2009 of a partner signature requirement in United Kingdom on audit quality. They find in the first year after the introduction of the signature requirement, a significant decline in abnormal accruals and the propensity to meet an earnings threshold, and a significant increase in the incidence of qualified audit reports and in earnings informativeness. In one of the few research studies that relate to audit costs, they also find that audit fees are significantly higher in the post-signature period than in the pre-signature period

ANALYSIS OF THE IAASB PROPOSITIONS

21. In this section we analyse the keys proposals in the IAASB exposure draft. For each proposal, we describe the proposal and evaluate its degree of responsiveness to stakeholders demands identified in Mock et al. (2013) and presented in column (a) of table 1. For each item listed in column (a), we present in column (b) our assessment, given existing research, of how each of the IAASB proposals respond to the information line items on a three-level scale (YES, POSSIBLY, NO) and reference to the paragraphs in our comment letter where this issue is discussed. In the last column (c), we indicate the level of evidence from prior

research supporting our conclusion on a four-level scale (AMPLE, MODERATE, MINIMAL, NONE).

(A) New section in the audit report describing Key Audit Matters [KAMs]

22. The IASASB exposure draft includes the disclosure in a new section of the audit report of matters that were of most significance in the audit. These matters are to be selected among matters communicated with those charged with governance and include areas identified as significant risks, areas involving significant auditor judgment, and areas in which the auditor encountered significant difficulty during the audit, or required significant modification of the auditor's planned approach.
23. As indicated in table 1, stakeholders want more information about the entity (Panel A) and the audit (Panel B). In its June 2012 Invitation to Comment (2012) the IAASB proposed the concept of 'auditor commentaries' which focused on matters most important to users' understanding of the audited financial statements or the audit. Because of objections to having auditors report information about the entity, instead of management and those charged with governance, the 2013 exposure draft has restricted the communication only to matters about the audit, i.e. Key Audit Matters. By doing so, the IAASB is not responding directly to some of the stakeholders' demands. However, as indicated by the IAASB (2013, 20), matters that were of most significance in the audit "Assist users of the financial statements in understanding the entity and areas of significant management judgment in the audited financial statements, as such matters are areas of focus in performing the audit." Accordingly, Key Audit Matters may respond in part to users' needs regarding the entity.
24. Regarding users information needs about the audit, given their definition, the Key Audit Matters have the potential to respond to users' needs, as the auditors apply the standard as expected by standard setters. Evidence on the French experience from a consulting firm (Footprint Consultants 2011) suggests that the justification of assessments are excessively standardized and reserved. However, as indicated previously we are not aware of any published academic research study on this topic.

(B) Auditor's conclusions related to management's use of the going concern assumption

25. The IAASB exposure draft proposes a new section entitled Going Concern in the audit report making explicit the auditor's conclusions on the appropriateness of management's use of the going concern basis of accounting and the absence of material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In addition, as in current standards, the information now disclosed in the auditor emphasis of matter paragraphs when material uncertainties are disclosed in the financial statements will be disclosed in the new Going Concern Section of the auditor report.

26. Research on the effect of going-concern opinion suggests that unless “new” information is provided in the audit report, a going concern audit report does not appear to have information content. Accordingly, given that the going concern information is already in the financial statement notes, the information about the going concern basis of accounting, may not have information value. However, the auditor is making visible a conclusion about a specific assertion that is now imbedded within the opinion on the financial statements. The users may then perceive that the auditor is giving a specific opinion on this assertion. However, we are not aware of published research on this issue.
27. One of the main catalysts to the proposed changes in the audit report appears to be the lack of auditor warning for financial institutions which revealed huge losses from 2007 to 2009 (e.g. European Commission 2010), suggesting that the problem might be more an “expectation gap” than an “information gap” problem. Accordingly, the proposed changes in the audit report might not be a significant answer to the problem. Improving accounting standards and auditing standards on going concern may be better ways to deal with these issues.

(C) Identification of the engagement partner’s name.

28. Mock et al. (2013) reported scarce and mixed research evidence on this topic and referenced a commentary by King et al. (2012) that applied insights from three academic frameworks of source credibility; accountability; and the theory of affordances. From their analysis they note that there may be unintended consequences from the proposed changes in this area. While they suggest that the changes may increase perceived audit quality, they highlight that there is scarce empirical evidence on whether the changes will increase audit quality in fact.
29. A recent study to address this question was by Carcello and Li (2013) who examined a number of consequences associated with the engagement partner signing the audit report in the United Kingdom. The results suggest high audit fees as a result of the requirement, but also higher audit quality and earnings information. The authors also compared a sample of U.K. firms with a sample of similar U.S. firms, and the results suggest higher audit quality due to the audit partner signature. This study provides evidence of the benefits and costs of the audit partner signing their name. However, it does not address the question of whether the benefits exceed the costs. Of course, the other point to note on this topic that was highlighted by Mock et al. (2013) is that many countries around the world have been doing this for years with no apparent adverse effects.
30. This recent research suggests a signature requirement may be beneficial. However, more research on this topic to confirm these results would be beneficial.

(D) Auditor’s conclusion regarding the outcome of auditor’s responsibilities with respect to documents containing or accompanying audited financial statements

31. The IAASB exposure draft proposes to be disclosed in the audit report a description of the auditor's responsibilities with respect to other information, an identification of the specific documents the auditor has read and considered, and a statement as to whether the auditor has identified material inconsistencies in the other information. Evidence from survey, focus group, and archival studies indicates that users demand the information in MD&A and find it useful. The research evidence also provides some support for the provision of assurance on MD&A presentations. The proposed communications, in particular the auditor conclusion regarding the identification of material inconsistencies in the other information, will likely reduce the information gap. However, there is little evidence on the nature of the auditor work regarding these other documents and how the auditors apply the current standards.
32. Whether, these disclosures will decrease the "expectation gap", depend on the additional work that will be required in the revised International Standard on Auditing (ISA) 720 – The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon. In this comment we do not comment on the November 2012 Exposure draft ISA 720 (Revised).

(E) Explicit statement regarding the auditor's independence and the sources of the independence requirements

33. The IAASB exposure draft proposes that the auditor disclose the source(s) of the specific independence and other relevant ethical requirements or applicable law or regulation. Survey results indicate that stakeholders desire information on auditor independence. Thus, such disclosure has the potential to reduce the information gap, since users will be able to "know" which requirements the auditors followed. However, the reduction in information gap will be limited because users may lack knowledge of the requirements referenced and auditor may refer to multiple requirements. In addition, research studies show that users' perception of independence is affected by the level and nature of non-audit services provided, and the length of the auditor relationship with the company. Except for public companies, for which audit fees including fees for non-audit services are often disclosed in filing documents, such information will not be disclosed to the users and accordingly, the information gap may not be significantly reduced.

Table 1: An analysis of how the IAASB Exposure Draft responds to the “information gap”

Panel A Information Gap Items Related to the Entity

(a)	(b) IAASB proposal and degree of responsiveness to stakeholders demands	(c) Level of evidence from prior research
Financial Statements:		
<ul style="list-style-type: none"> Accounting policies and practices <ul style="list-style-type: none"> Management's judgments and estimates Difficult or contentious issues, including "close calls." Material Matters Component of a larger business enterprise. Significant transactions with related parties Unusually important subsequent events Accounting matters affecting the comparability of the financial statements Most significant matters in the financial statements 	<p>(A) Disclosure of Key Audit Matters POSSIBLY: These items may be included in the KAMs reported in the audit report (par. 23)</p>	<p>MINIMAL, no published academic study on the topic, only one study from a consultant.</p>
<ul style="list-style-type: none"> Going concern 	<p>(B) Auditor's conclusions related to management's use of going concern. POSSIBLY: Stakeholders demands appear to be more for improved early warning for bankrupt companies, than improved communication in the audit report. Thus, unless increased disclosure in the audit report change the auditor behaviour, the IAASB proposal might not respond to users' needs (par. 26-27).</p>	<p>MINIMAL, few research studies on the effect of the audit report on auditor judgment regarding going-concern.</p>
Information Gap Items: Other Information:		
<ul style="list-style-type: none"> Management forecasts Quarterly financial statements Non-GAAP information Earnings releases Internal controls over financial reporting Key performance indicators Corporate governance arrangements Sustainability information MD&A 	<p>The 2013 IAASB exposure draft has restricted the communication only to matters about the audit, i.e. Key Audit Matters</p>	

Table 1: An analysis of how the IAASB Exposure Draft responds to the “information gap” (continued)

Panel B Communication Gap Items: Audit

	IAASB proposal and degree of responsiveness to stakeholders demands	(c) Level of evidence from prior research
• Materiality	The 2013 IAASB exposure draft does not explicitly consider this. However, the disclosure of key audit matters could provide information on this.	NONE: No published academic study directly relevant to this topic,
• Auditor independence	(E) A statement that the auditor is independent of the entity within the meaning of the relevant ethical requirements or applicable law or regulation and has fulfilled the auditor’s other responsibilities under those requirements. POSSIBLY: The disclosure will partially respond to the demand, since research show that users care about other independences issues such as non-audit services and audit firm tenure. (par. 33)	MODERATE: Research shows that users react to information about some independence issue such as the level of non-audit services, but there is no research on the value of information about the independence requirement followed by the auditors.
• Role of other auditors involved in the audit	The 2013 IAASB exposure draft does not explicitly consider these. However, the disclosure of key audit matters could provide information on these.	NONE: No published academic study directly relevant to this topic
• Reasonable assurance		
• Auditor’s responsibility for fraud		
• Auditor’s responsibility for financial statement disclosures	An enhanced description of the auditor’s responsibilities is required POSSIBLY: The required enhanced descriptions may reduce the information gap.	NONE: No published academic study directly relevant to this topic
• Management’s responsibility for the preparation of the financial statements		
• Auditor’s responsibility for information outside the financial statements	(D) Communication of the auditor’s responsibilities with respect to information in documents containing or accompanying the financial statements and of whether the auditor has identified material inconsistencies in the other information YES: The proposed standards have the potential to reduce the communication gap. (par. 31-32)	MODERATE: Research shows a need for information, but there is no information as to whether communications of the auditors responsibilities affects users’ perceptions
• Significant audit risk, audit procedures responsive to theses risk, and results of these procedures	(A) Disclosure of Key Audit Matters YES: These items are included in the KAMs reported in the audit report (par. 22-24)	MINIMAL: No published academic study on the topic, only one study from a consultant.
• Significant risks, issues of significance related to the audit scope or strategy, difficult or contentious matters noted during the audit		
• Audit partner name	(C) Required disclosure of partner’s name for listed clients. YES: For public companies, the requirement will respond to stakeholder demand for partner name. In addition, research results suggest that such disclosure seems to improve audit quality. (par. 28-30)	MINIMAL: Research has examined the effect of mandatory disclosure of partner name in the United Kingdom.

CONCLUSION

34. In summary, the IAASB exposure draft has the potential to reduce the information gap on items related the entity financial statements and the communication gap on some audit items. However, as shown by the grey cells in Table 1, the exposure draft does not address items related to other information about the entity, such as internal controls over financial reporting and MD&A where there is a clear demand from stakeholders and where the U.S. experience with internal controls over financial reporting has shown that such information has value. Similarly, many audit items such as materiality and the role of other auditors involved in the audit, are not addressed in the exposure draft.
35. Regarding the level of prior research, the last column of Table 1 shows a lack of strong evidence regarding the various propositions. Most of the evidence is minimal or moderate, which makes it difficult for standard setters and regulators to base their standards on research results. Several factors may explain this lack of evidence in academic journals. One relates to timing as some of the proposals are relatively new. While researchers may be studying them, the output of these studies are still at the working paper stage and obtaining the “seal of approval” of an academic journal is often a lengthy process. We have not considered working papers in this comment. A related possible cause may be the lack awareness of the IAASB agenda early enough for timely researching the issue. Lack of access to data and inadequate research support in general may also contribute to the lack of research evidence.
36. This research evidence “gap” suggests the need for the IAASB to more closely work with the auditing research community and to provide or facilitate increased support to auditing researchers to study matters that will be subject to standard deliberations in the future, including facilitating the evaluation of the impact of the standards.

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