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Improving Transparency and Relevance of Auditor Communications with Financial Statement Users

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SUMMARY: Recent SASs (e.g., SAS No. 114 (AICPA 2006b) and SAS No. 115 (AICPA 2008a)) expand required and optional communications from auditors to their clients. Given that some state laws likely allow stockholders to request access to those communications, and given that the ASB and the IAASB currently are examining how the auditor's report may be made more effective in communicating assurance to financial statement users, we propose expanding the current auditor's report by adding a set of accompanying footnotes. The footnotes could include auditor comments on information about the audit, the quality of the financial statements, the quality of the financial reporting system, and/or the quality of the client as a business entity. We conclude with suggestions for research that would identify the effects of suggested communications on various stakeholders.

INTRODUCTION

A recent research project by Mock et al. (2009; hereafter MTGC), commissioned by the American Institute of Certified Public Accountants (AICPA), Auditing Standards Board (ASB), and the International Auditing and Assurance Standards Board (IAASB), explored user perceptions of the unqualified auditor's report. MTGC found little evidence that the information provided in the current auditor's report is utilized in users' decision-making, and that there are additional disclosures and communications that users would like to see as part of the auditor's reporting process. This article builds on the MTGC findings by providing some ideas for expanding disclosures by auditors to financial statements users, based on changes that have occurred to auditor/client communication requirements.[1]

Recent Statements on Auditing Standards (SASs) issued by the ASB have increased the nature and depth of required and optional communications between the independent auditor and client management and/or those charged with audit client governance. Included in those Statements are SAS No. 114 (AICPA 2006b) and SAS No. 115 (AICPA 2008a). SAS No. 114 (AICPA 2006b), for example, indicates that auditors should communicate significant findings from the audit, including their views about qualitative aspects of clients' significant accounting practices, any significant difficulties encountered during the audit, any uncorrected misstatements other than those the auditor believes are trivial, any disagreements with management, and any other findings

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or issues arising from the audit the auditor judges to be significant and relevant to those charged with governance. SAS No. 115 (AICPA 2008a) further requires auditors to communicate in writing to management and those charged with governance any significant deficiencies and material weaknesses identified during the audit.

Expanded auditor/client communications introduces issues requiring consideration both within the profession and by additional academic research. Prior court cases indicate that stockholders in the U.S. may have legal access to any auditor/client communications. For example, Delaware Corporations Code §220 permits stockholder inspection and copying of a corporation's stock ledger, list of stockholders, and "other books and records." Delaware courts have interpreted the phrase "other books and records" to cover a wide variety of corporate documents, including memoranda, email, letters, minutes, resolutions, invoices, agreements, ledgers, and other documents, and even extends to the books and records of a corporation's subsidiaries (Brody et al. 2008).[2] It appears that, depending on the state of incorporation and the specific laws in that state, any auditor communications pursuant to SAS Nos. 114 (AICPA 2006b) and 115 (AICPA 2008a) may have to be disclosed to any stockholder requesting such communications.[3]

In this paper, we examine some issues derived from the MTGC research that were perceived as important by users and that are not currently disclosed to users, but are now required to be disclosed by auditors to their clients. Such enhanced disclosures may reduce communication problems that contribute to the expectation gap that has been shown to exist across many jurisdictions (e.g., Australia: Monroe and Woodliff 1994; U.K.: Innes et al. 1997; and U.S.: McEnroe and Martens 2001). We consider four categories for expanded disclosure, including information about the:

- audit;
- quality of the financial statements;
- quality of the financial reporting system; and
- sustainability of the business.

We then consider how the auditor's report could be expanded to communicate at least some of those items to financial statement users. There are, of course, many cost/benefit issues associated with any such changes; however, this cost/benefit discussion is beyond the scope of this paper. In the final section, we identify six critical areas for future research, including cost/benefit issues, that should be undertaken before changes related to expanded disclosures are made to the auditor's report.

BACKGROUND

The MTGC (2009) research project included two studies that were performed in response to a Request for Proposal (RFP) for research from the AICPA, ASB, and the IAASB. The RFP stated that, "The key research objective is to identify and provide information about users' perceptions of

[2] Two international pronouncements, ISA 260 (IAASB 2008) and ISA 315 (IAASB 2006), include communications requirements similar to those of SAS Nos. 114 (AICPA 2006b) and 115 (AICPA 2008a). Because stockholder rights outside the U.S. likely vary by political regime, our recommendations are directed primarily toward U.S. auditor's reports.

[3] As the Public Company Accounting Oversight Board (PCAOB) now issues standards for audits of publicly-traded companies and does not recognize ASB auditing standards issued after April 16, 2003, the potential disclosures discussed in SAS Nos. 114 (AICPA 2006b) and 115 (AICPA 2008a) do not apply to audits of such companies. Some communications required by the PCAOB, such as those related to internal controls, fraud, illegal acts, and uncorrected misstatements, are consistent with ASB standards. Even in a PCAOB-based audit, however, any communications between auditors and their audit clients may be subject to disclosure through stockholder requests. The PCAOB currently is considering auditing standards relating to the auditor's assessment of and response to risk that could affect the nature of the communications described above (PCAOB 2009).

the financial statement audit in connection with reading and considering the auditor's report." In the first study, MTGC conducted focus groups with auditors and a number of important user groups, including analysts, bankers, CFOs, and individual investors, to evaluate their perceptions concerning an unqualified auditor's report. In the second study, MTGC used verbal protocol analysis with financial analysts to examine the effects of unqualified auditor's reports on analysts' decisions and judgments.

Overall, MTGC found that the auditor's report *per se* is deemed important by users. However, all of the user groups expressed very little interest in reading the actual content of the auditor's report. This lack of interest may in part be attributable to the homogeneity of the content of an unqualified report. Some participants in the MTGC studies suggested that an adequate replacement for the current auditor's report could be a simple auditor's "checkmark of approval." These broad findings are consistent with the Church et al. literature review, which concludes that the auditor's report "has symbolic value, but conveys little communicative value" (Church et al. 2008, 85). In summary, it appears that users have a preconceived understanding of the "meaning" of an unqualified auditor's report; once this fact is confirmed, there is no need for further evaluation of the report.

However, despite this lack of interest in the content of the auditor's report, there were some areas where user groups were incorrect or confused about the exact message the auditor's report is intended to convey. Many of these issues correspond to topics covered by SAS Nos. 114 (AICPA 2006b) and 115 (AICPA 2008a) and have been recommended for disclosure in previous research (e.g., De Martinis and Burrowes 1996; Manson and Zamon 2001; Church et al. 2008).

POTENTIAL INFORMATION TO ACCOMPANY THE AUDITOR'S REPORT

The RFP noted the following: "The ASB and IAASB believe that the interests of all stakeholders will be better served if any gaps between user understanding and the intended meaning of the report, including the level of assurance that can reasonably be derived from a financial statement audit, can be identified and addressed." In the spirit of this suggestion, we provide an evaluation of a possible broader audit reporting model that could include some items already required to be disclosed by auditors to clients. Disclosure of these items will have the joint benefit of providing information beneficial to users of the auditor's report while also providing information that will *vary* from client to client. Based on the MTGC findings, these disclosures should improve the communicative value of the report. These additional disclosures include information about the audit, the quality of the financial statements, the quality of the financial reporting system, and the sustainability of the business, each of which we discuss in more detail below.

The Audit

Among the topics that might be disclosed, two appear to be particularly worthy of additional research and consideration: 1) level of assurance provided and reporting materiality; and 2) information about auditor independence.

Level of Assurance Provided and Materiality

MTGC found that the level of assurance provided by an unqualified auditor's report and the related level of reporting materiality are critically important concepts, yet they are among the least understood by financial statement users. As reporting materiality represents the underlying precision of audited financial information, materiality levels have been found to significantly impact issues such as the calculation of earnings per share (Turner 2007) and the levels of widely-used financial ratios (Turner 1997). Such precision also is related to the level of assurance provided by the auditor and potentially would provide useful information to financial statement users. Still, reporting materiality levels are not disclosed and users have no basis for evaluating the impact of reporting materiality levels on their decisions.

An indication of reporting materiality can be seen in the level of misstatements considered non-trivial by the auditor and used as a basis for discussions about possible corrections held between the auditor and the audit client and/or those charged with governance. The auditor can only suggest corrections, not make them. Client management decides whether to make corrections and the auditor decides whether to modify the opinion if corrections are not made. Negotiations may lead management to make some corrections and not others, and the auditor then decides whether the corrections made result in financial statements that are fairly stated.

Both SAS No. 107 (AICPA 2006a) and SAS No. 114 (AICPA 2006b) require the auditor to inform those charged with governance about "the implications of a failure to correct known and likely misstatements, if any, considering qualitative as well as quantitative considerations, including possible implications in relation to future financial statements" (AICPA 2006b, ¶41). Disclosure by the auditor of all uncorrected misstatements discussed with the client, including with those charged with governance, would allow each financial statement user to make an independent evaluation of the materiality of those uncorrected misstatements for his or her specific needs.[4]

For example, some users might evaluate the impact of uncorrected misstatements on net income and earnings per share while other users might have greater interest in the impact on balance sheet accounts, such as inventory or accounts receivable. Disclosure of uncorrected misstatements may result in management correcting all known misstatements, effectively reducing the negotiations that sometimes result in an Enron-type fraud.[5] Further research should examine the impact on user decisions of disclosing uncorrected misstatements in conjunction with the auditor's report.

Independence

Although the auditor's report explicitly refers to the auditor's independence, SAS No. 114 (AICPA 2006b) indicates that, in some circumstances, the auditor may determine that "it is appropriate to communicate circumstances or relationships (for example, financial interests, business or family relationships, or non-audit services provided or expected to be provided) that in the auditor's professional judgment may reasonably be thought to bear on independence and that the auditor gave significant consideration to in reaching the conclusion that independence has not been impaired."

Quality of the Financial Statements

Generally accepted accounting principles (GAAP) require entities to make accounting estimates and judgments about qualitative aspects of accounting practices, including accounting policies, accounting estimates, disclosures, and related items. As discussed in SAS No. 114 (AICPA 2006b), open and constructive communication with those charged with governance about qualitative aspects of the entity's significant accounting practices may include comments related to the acceptability of those practices. An expanded auditor's report could include the auditor's judgments about the quality, not just the acceptability, of the entity's accounting practices as

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

[5] For a review of negotiation research in auditing, see Brown and Wright (2008).

applied in its financial reporting.[6] Where acceptable alternative accounting practices exist, the communication may include identification of the financial statement items that are affected by the choice of significant practices, as well as information on accounting practices used by similar entities.[7]

If the auditor disagrees with management about significant accounting practices, the auditor could explain the basis for the disagreement and offer an explanation as to why an unqualified audit opinion still was appropriate. The discussion generally could include such matters as the consistency of the entity's accounting practices and accounting estimates, their application, and the clarity and completeness of the entity's financial statements, including related disclosures.

Quality of the Financial Reporting System

SAS No. 115 (AICPA 2008a) requires auditors to communicate, in writing to management and those charged with governance, control deficiencies identified during the audit that upon evaluation are considered to be significant deficiencies or material weaknesses. Communications provided to management and those charged with governance illustrated in SAS No. 115 (AICPA 2008a, Appendices A and B) also could be a basis for disclosure to all users. Future research should examine not only the potential usefulness of internal control opinions such as those required under PCAOB Auditing Standard No. 5 (PCAOB 2007), but also the usefulness of non-opinion-based disclosures such as those required under SAS Nos. 114 (AICPA 2006b) and 115 (AICPA 2008a).

Sustainability of the Business

As a result of performing an audit, the auditor has access to relevant information about specific risks faced by the client and how they relate to the viability of the audit client as a business entity. That information could provide valuable input into a user's analysis of the financial statements. For example, SAS No. 59 (AICPA 1988) requires the auditor's report to be modified to express auditor reservations about the entity's ability to continue as a going concern. Both SAS Nos. 59 (AICPA 1988) and 114 (AICPA 2006b) indicate that, among other items to communicate to those charged with governance, auditors should discuss the issues involved and related judgments made in formulating particularly sensitive financial statement disclosures such as those related to going concern evaluations.

MTGC (2009) identified going concern evaluations as an area where additional disclosures may be helpful. Further research can focus not only on the nature and detail of potential disclosures to financial statement users, but also on how a closer alignment of the auditor's intended level of assurance associated with a going concern unqualified auditor's report and user perceptions of that assurance can be achieved. Disclosure of the auditor's decision processes may be particularly important in light of changes currently being considered by the Financial Accounting Standards Board related to the definition of going concern including that, while the time period for the going concern assessment is not a bright-line 12 months, it is not intended to be an indefinite look-forward period (FASB 2010).

Additional information associated with going concern evaluations could be of interest to

[6] In France, auditors currently are required to bring to the attention of users of the financial statements information concerning items that are the subject of significant accounting judgments or estimates. The auditor does not assess the "quality" of these assessments, but rather discusses some of the key areas focused on during the audit (ICAEW, 2007).

[7] Transition from U.S. GAAP to International Financial Reporting Standards (IFRS) may make such disclosures even more valuable to financial statement users because the more principles-based IFRS may allow management greater flexibility to choose among alternative accounting practices.

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

METHOD OF DISCLOSURE

There are several different options for changing the auditor's report. One option would be to follow the style of the French auditor's report that includes a section called "Justification of Our Assessments." This section discusses items that were the subject of significant accounting judgments or assessments, such as asset impairment, litigation, retirement benefits, and deferred taxes (ICAEW 2007). A more radical change would be a "free form" auditor's report that does not follow standard wording, but rather is tailored to each audit (Hatherly et al. 1998).

The easiest and most flexible method, however, would be to retain the current form of the auditor's report and add a set of footnotes containing the additional disclosures discussed in this paper. The report still would be addressed under current guidelines, but would have a notation similar to that included in the footnotes to the financial statements (e.g., "The accompanying footnotes are an integral part of this Independent Auditor's Report"). Such footnotes would not replace auditor communications to management or those charged with governance required under present pronouncements, and possibly could be in more condensed form. This enhanced auditor's report would include footnotes, possibly differing both in nature and detail from company to company, and would provide relevant information that users of the financial statements would find useful, thereby improving the clarity and usefulness of the auditor's report.

THE NEED FOR FUTURE RESEARCH

Clearly, changes in the auditor's report, either in content or style, should not be made for the sake of change alone. The focus of this paper is on information required to be communicated by the auditor to the client and those charged with governance, but not currently disclosed to other users. Importantly, these communications cover topics that have been found to be important to users in the MTGC (2009) study and in other research. This paper has summarized an array of possible disclosures identified by MTGC.

However, if there were increased disclosure of this information to users, the type of information that would be disclosed and the degree of detail to be communicated should be considered carefully from several viewpoints. Consequently, we see six general sets of issues that should be considered by academics, practitioners, and standard setters before changing the current form of the auditor's report:

- Effects on User Demands: How will greater transparency about financial statement content and the audit process affect financial statement users' demands for a specific level of assurance and how can auditors respond to meet possible variations in demand?
- Effects on Financial Statement Users' Decision Making: Of the various types of information that might be disclosed, which would be useful in decision-making, which might be confusing or misleading, in what form should the information be disclosed, and how would the level of assurance perceived by financial statement users be affected?
- Effects on Risk Profiles: Before any additional disclosures are approved, it is important to examine how additional disclosures will affect the risk profiles of both the auditors and their audit clients in terms of legal exposure. Although the Private Securities Re-

form Act of 1995 reduced auditor exposure to some types of legal action, legal liability still is an issue of concern for auditors. Will such disclosures increase auditor liability or reduce the auditor's legal exposure by establishing a more clearly defined level of assurance? Is some form of safe-harbor law necessary to protect auditors and their clients?

- Effects on Costs and Fees: As all of the information that we suggest for consideration already is required by existing professional guidance, it cannot be assumed that public disclosure will increase audit costs or fees substantially. Future research should examine potential changes in audit fees resulting from expanded disclosure requirements to assess the balance between the costs and benefits of these possible changes.
- Effects on Confidentiality: Rule 301 of the AICPA Rules of Conduct states that "A member in public practice shall not disclose any confidential client information without the specific consent of the client" (AICPA 2008b). Future research should consider the types of extra disclosures that might be considered confidential and evaluate the likelihood of clients allowing such disclosure, as well as possible options available for auditors if a client restricts what auditors could include as part of the auditor's report.
- Effects on Auditor Communications with the Client: What impact would public disclosure of items contained in SAS Nos. 114 (AICPA 2006b) and 115 (AICPA 2008a) and other SASs have on communications previously assumed to be relatively privileged between auditors, client management, and those charged with governance? Would such disclosures result in auditors or clients being less forthcoming with useful observations both in the type of information disclosed and the detail provided because such communications also would be disclosed publicly? Research should evaluate the perceptions of auditors, management, and those charged with governance on this issue.

These issues and related sub-issues clearly require careful examination from technical, behavioral, political, and legal viewpoints. However, with the recent increases in required communications between auditors, management, and those charged with governance and the possible legal access to those communications by stockholders, it is imperative that such aspects be considered expeditiously. The outcome of the suggested future research and discussions among auditors, clients, and standard setters could result in an auditor's report that provides client-specific information and that is more than just the homogeneous "checkmark of approval" perceived by financial statement users (MTGC 2009).

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