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Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors

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SYNOPSIS: U.S. and international auditing standard setters continue to raise questions about standard auditors' reports and are exploring alternatives to those reports. Government agencies and professional organizations are also raising questions about the auditor's report. These questions point to a continued existence of an "audit expectation gap." To investigate perceptions and misperceptions regarding the auditor's report, we conducted focus groups with five different stakeholder groups—financial statement preparers (CFOs), users (bankers, analysts, and non-professional investors), and external auditors. This approach allows detailed comparisons between the perceptions of the different stakeholder groups affected by the auditor's report. Findings include that financial statement users value the audit, but do not read the entire auditor's report. It is not clear to users, preparers, and auditors what the auditor's report is *intended* to communicate or the *level of assurance* being provided by the report. Stakeholders offered numerous suggestions to improve the auditor's report, but they also recognize those suggestions could significantly change the auditor's risk profile and increase audit fees. We suggest future research to determine if potential changes to the auditor's report would change users' behavior and if any resulting benefits outweigh the additional risks and costs.

Keywords: auditor's report; audit expectation gap; auditor disclosures; audit stakeholders; focus groups.

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INTRODUCTION

Although standard auditors' reports vary across political boundaries, both U.S. and international auditing standard setters continue to express concerns about the content and usefulness of those reports (American Institute of Certified Public Accountants [AICPA] and International Auditing and Assurance Standards Board [IAASB] 2006; Public Company Accounting Oversight Board [PCAOB] 2010).[1] The objectives of this study are to identify the perceptions and misperceptions regarding the current unqualified auditor's report and to identify suggestions to improve the auditor's report. Regulators, government agencies, professional groups, and other auditing overseers also continue to raise concerns about the auditor's report. For example, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession's (ACAP) *Final Report of the Advisory Committee on the Auditing Profession for the U.S. Department of the Treasury* (hereafter, *Final Report*) specifically urges the Public Company Accounting Oversight Board (PCAOB) "to undertake a standard setting initiative to consider improvements to the auditor's standard reporting model" (ACAP 2008, VII:13). As a result, the PCAOB has included the audit reporting model topic on the agenda for its Standing Advisory Group (SAG) meetings.[2]

At a public meeting in March 2011, the PCAOB Office of the Chief Auditor reported to the PCAOB on its outreach to investors and others about potential changes to the auditor's reporting model. During the same week, the PCAOB Investor Advisory Group presented recommendations to the Board on changes to the auditor's report, and the SAG also discussed the auditor's report. Martin F. Baumann, Chief Auditor and Director of Professional Standards, said, "The auditor's reporting model is a top standard-setting priority of the Board. To better inform their investment decisions, investors say they need to hear more from the auditor about the risks the auditors faced in the audit and about the judgments and estimates management used in the financial statements" (PCAOB 2011). The PCAOB plans to issue a concept release regarding modifications to the auditor's report as early as mid-2011.

On the user side, the CFA Institute published a report, *Independent Auditor's Report Survey Results*, which summarizes financial analysts' opinions on several questions regarding the auditor's report (CFA 2010). Only 37 percent of respondents indicate they believe the current auditor's report contains "the right amount of information."

In the European Union, a Green Paper, *Audit Policy: Lessons from the Crisis*, discusses several audit-related issues, including how auditors can better communicate their work (European Commission 2010). The Green Paper notes that "Given that these stakeholders may be unaware of the limitations of an audit (materiality, sampling techniques, role of the auditor in the detection of fraud, and the responsibility of management), this engenders an expectation gap" (European Commission 2010, 3–4). In reference to this Green Paper, Paul Boyle, the Chief Executive of the United Kingdom's Financial Reporting Council (FRC), said, "The gap between what audit does and what users expect from an audit of the financial statements has been growing for the last 20–30 years, despite previous attempts to bridge it" (Haddrill 2011, 3). Further, he said that now is the time for "fresh thinking."

Expressing concerns about the auditor's report has a long history, dating back to the early 1900s (Church et al. 2008; King and Case 2003; Koh and Woo 1998; PCAOB 2010). As included in the Green Paper quotation above, the profession refers to these concerns as the "expectation gap"

[1] Current versions of the auditors' reports are included in Statement on Auditing Standards No. 58 (SAS No. 58) (AICPA 1988), International Standard on Auditing 700 (ISA 700)(IAASB 2010), and Auditing Standard No. 5 (AS5)(PCAOB 2007).

[2] The schedule for future SAG meetings and SAG meeting archives are available at: http://pcaobus.org/Standards/SAG/

or the "audit expectation gap." Porter (1993) provides a definition of the audit expectation gap and suggests the gap has two major components:

- *Performance gap*: A gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve.
- *Reasonableness gap*: A gap between what society expects auditors to achieve and what they can be reasonably expected to accomplish.

At first glance, these two definitions look almost identical with some minor word switches, but Porter (1993) captures two different concepts. The performance gap is based on what society could reasonably expect that auditors *should* do—not what existing auditing standards say auditors are supposed to do. Porter (1993) further subdivides the performance gap into two more-detailed gaps: (1) the "deficient standards" gap, which is the gap between what auditors *should* do and what auditors *would* do if they absolutely complied with the auditing standards, and (2) the "deficient performance" gap, which is the perceived gap between what auditors actually do and the requirements of the standards. While the performance gap is based on an ideal, but *reasonable*, set of achievements, the reasonableness gap is society's *unreasonable* expectations beyond those reasonable achievements.

The past attempts by the profession to reduce the expectation gap primarily have been to deal with unreasonable expectations, as opposed to changing the standards. The Auditing Standards Board (ASB) amended the auditor's report to "educate" users and to correct users' misperceptions as to the auditors' responsibilities. However, the fact that the expectation gap continues to persist suggests these past attempts have been unsuccessful. Some researchers have been critical of these past attempts. Humphrey et al. (1992) suggest that changes in the auditor's report ensure the audit expectation gap debate is framed in terms of improving the understanding of users rather than providing more information on the nature and quality of audit performance. They further state:

> This is well reflected in the move towards longer-form audit reporting, where the dominant emphasis has been on providing information on generalized audit responsibilities rather than the detailing of specific considerations and findings affecting the enterprise which has been audited. The intention, therefore, appears to be to *give to readers more information about auditing, rather than more information about the results of the audit*. (Humphrey et al. 1992, 147; emphasis added)

More recently, in an article on the role of audit in the context of the increasing complexities of the financial system and recent financial crisis, Humphrey et al. (2009, 819) note that the auditor's report is not particularly helpful, "being full of general, standardized statements on the role and limitations of the audit and containing little about the specific work undertaken and findings obtained by auditors."

Our research contributes in two ways to understanding why the expectation gap continues to persist despite changes to the auditor's report. First, the study includes five diverse stakeholder groups—financial statement preparers (CFOs), users (bankers, analysts, and non-professional investors), and external auditors. Most existing auditor's report research includes just one of these stakeholder groups. Since extant research may have different research questions, hypotheses, and research settings and techniques, it is difficult to compare and synthesize results and perceptions across stakeholder groups from different research studies. For our research, each stakeholder group uses the same basic set of research questions, allowing us to fully synthesize and compare the perceptions of the five groups.

Second, we use focus groups as our research method to provide deeper insights into stakeholders' perceptions. The contemporaneous interactions of the focus group participants and the opportunity to ask the participants follow-up and probing—and sometimes argumentative—

questions provided a wide variety of findings regarding the auditor's report and the expectation gap. As anticipated, some of our findings support conclusions reported in prior research. Also, we provide new results, as well as additional perspectives on prior findings that would be difficult to discover with other research techniques.

Researchers frequently use focus groups to explore stakeholder perceptions and policy-related issues in other domains. In the accounting domain, the AICPA (Williamson 2007), Public Oversight Board (POB) (2000), IRS (Shoemaker 2008), GAO (Crain and Bean 1998), and others have used focus groups. Yet, a search of academic databases results in locating only one paper in the academic audit research domain that used focus groups (Boritz 2005). As such, the description of our focus group research design is relatively detailed to provide guidance to researchers who want to use this research method in the future.

Most of the extant research on the auditor's report is from the 1980s and 1990s, subsequent to the most recent change to the report format. Much has changed in the audit environment since the early 2000s, with major scandals (e.g., Enron, WorldCom, etc.) leading to the demise of Arthur Andersen, passage of the Sarbanes-Oxley Act of 2002 (SOX), and creation of the PCAOB. Although audit standard setters, regulators, and other professional groups have been raising concerns about the auditor's report, other post-SOX auditor's report studies have researched much more focused topics, such as the market reaction to the inclusion of the internal control opinion in the PCAOB-based auditor's report. This study provides the only *wide-ranging* post-SOX research study regarding the auditor's report expectations gap.

We discuss our detailed findings in the "Results" section; however, four general insights are seen. First, the *intended* communications of the auditor's report is an elusive concept to preparers, users, and auditors. This suggests that gauging the exact nature of *unintended* communications and, therefore, the expectation gap cannot be determined precisely. Second, users frequently misinterpret common terms in the auditor's report, such as *reasonable assurance*, *materiality*, and *sampling*. Even the participating auditors could not agree on the relationships between level of assurance and materiality. Third, users do not *read* the auditor's report. Instead, users *look* at the auditor's report to check if it has an unqualified opinion and to check the name of the accounting firm signing the report. Non-professional investors use secondary sources for financial data and never seek out the auditor's report. Regarding a redesigned auditor's report, participating bankers and analysts suggested that new material added to the auditor's report does not matter if that added material is boilerplate in nature—they still will not read the report. Users indicate they want to see client-specific content such as the information that would appear in a traditional management letter. Fourth, the majority of stakeholders believe that PCAOB-based audits are superior to ASB-based audits. Preparers (CFOs) observed that PCAOB-based audits are more rigorous, and users indicated that the PCAOB-based auditor's report, along with internal control opinions, provides more information about where management will be focusing future resources. Auditors indicated that the initial financial statement numbers presented by the client now are higher quality, because preparers know that any subsequent revision of the numbers during the audit could trigger a negative internal control opinion.

Our findings clearly indicate that audit standard setters will need to make significant changes to the auditor's report if they wish to reduce the misperceptions, the unintended communications, and the expectation gap that exist currently. It also provides evidence to support the definition of Porter (1993) that recognizes there are several different dimensions to the expectation gap. Stakeholders in this study suggested a variety of changes to improve the audit reporting model. Some changes would be relatively minor, while some could be paradigm shifts in terms of the relationships between auditors, client management, those charged with governance, and financial statement users. The participants also recognized that their recommendations have associated costs and may impact

the auditor's risk profile. Balancing benefits, costs, and risks will add to the audit standard setters' and regulators' challenges.

We have organized the remainder of this paper into five sections. The next two sections provide the background for our research and an overview of literature regarding the auditor's report. The third section provides the details of our focus group research design. The fourth section presents our results in the form of a synopsis of the focus groups' discussions. The final section provides concluding comments plus suggestions for future research.

BACKGROUND

This article expands on a research project commissioned by the AICPA's Auditing Standards Board (ASB) and the International Auditing and Assurance Standards Board (IAASB) (AICPA/IAASB 2006; Mock et al. 2009; Turner et al. 2010; Coram et al. 2011).[3] The ASB and IAASB have expressed concerns about miscommunications regarding their unqualified auditors' reports.[4] Specifically, their request for research proposals (RFP) stated, "financial statement users may not consistently understand the intended communications contained in the auditor's report." The phrase "intended communications" became an important aspect of our research because, as discussed in our research findings, there was no general agreement among participants as to the intended communications of the auditor's report. The applicable audit standards do not use that phrase, and even the auditors in our study had difficulty articulating and agreeing on the intended communications of the auditor's report.

The ASB and IAASB RFP stated that a key objective of the requested research was "to identify and provide information and insight on the nature of user perceptions regarding the financial statement audit and the auditor's report among various classes of financial statement and audit report users." The ASB and IAASB stated that they believe identifying and addressing gaps between user understanding and the intended meaning of the report will better serve the interests of all stakeholders.

We expanded on the ASB/IAASB study suggested in their RFP in two ways: first, by including the PCAOB audit standard setting activities and the ongoing reporting-model activities of the PCAOB's Standing Advisory Group (PCAOB 2010, 2011), and second, by more fully integrating our findings with findings of other research on auditors' reports.

The fact that the expectation gap is still an issue suggests that there has been a significant gap in the research. The primary focus of dealing with the expectation gap in existing literature has been to better explain the audit to users by expanding discussion in the auditor's report. This approach has addressed only the unreasonable expectations component of the expectation gap that Porter (1993) defines. As discussed in this paper, research subsequent to the last major auditor's report change (SAS No. 58) generally finds that users were better informed in the areas with revised explanations (e.g., Kelly and Mohrweis 1989; Miller et al. 1993; Kneer et al. 1996). However, research examining key expectation gap issues finds the expectation gap still exists and, in fact, has become wider in areas not addressed in the expanded auditor's report (e.g., Lowe 1994; Pringle et al. 1990; Geiger 1994).

An important issue missing from the extant research is a better understanding of what users want, instead of what the profession (or regulators) believes is wanted. The study by Porter (1993)

[3] Opinions expressed in this paper are solely those of the authors and do not reflect the opinions of the AICPA or IAASB.

[4] In addition to being the co-sponsor for our research project, the IAASB has a task force conducting a separate internal project, and is exploring ways to improve the communications of the auditor's report. A summary of the project is available at: http://www.ifac.org/IAASB/ProjectHistory.php?ProjID=0095

highlights that a proper understanding of the difference between society's expectations of auditors and auditors' perceived performance is the best way to start to reduce the expectation gap. Porter (1993, 66) says that identifying where expectation gap differences are the widest makes "appropriate corrective action . . . almost self-evident." By the innovative use of focus groups, this study is a significant step in gaining that understanding and encouraging the "fresh thinking" needed to help bridge the audit expectation gap. We organize our research around three overarching research themes:

- Theme 1: Overall perceptions regarding the audit and the auditor's report;
- Theme 2: Perceptions regarding key concepts incorporated or that could be incorporated in the current auditor's report; and
- Theme 3: Suggestions and challenges for improving the communication of the auditor's report.

LITERATURE REVIEW

Concerns regarding the auditor's report date to the early 1900s (Church et al. 2008; King and Case 2003; Koh and Woo 1998; PCAOB 2010). From 1948 through 1988, there was a growing perception that the financial statement users' interpretations of the auditor's report were different from the message auditors intended to convey. The Cohen Commission (1978) identified several areas needing improved communication. In addition to concerns about confusion over management and auditor responsibilities, the Commission indicated concern that the standardized language made the auditor's report a "symbol" that users did not carefully read. Nine years later, the National Commission on Fraudulent Financial Reporting (NCFFR) (1987) (the Treadway Commission) suggested that the auditor's report should indicate clearly that the intent is not to provide absolute assurance of no material misstatements resulting from error or fraud in the financial statements, and that the report should inform the user of the extent to which the auditors reviewed and evaluated the system of internal accounting controls (Kneer et al. 1996).

SAS No. 58 Auditor's Report

In 1988, the AICPA's ASB issued Statements on Auditing Standards (SAS) Nos. 53 through 61, collectively referred to as the "expectation gap standards," to improve communications between auditors and financial statement users (Geiger 1988; Guy and Sullivan 1988; Roussey et al. 1988; McEnroe and Martens 2001). SAS No. 58, *Reports on Audited Financial Statements* (AICPA 1988), provides a new auditor's report "to better public understanding of the auditor's role" (Roussey et al. 1988). The new auditor's report requires the auditor to address the responsibility being assumed by the auditor, the nature of audit procedures performed in conducting the audit, and the degree of assurance being provided.

After issuance of SAS No. 58, several studies (e.g., Kelly and Mohrweis 1989; Miller et al. 1993; Kneer et al. 1996) show that the new (SAS No. 58) auditor's report effectively improves users' ability to distinguish between auditor and management responsibility. However, research also finds misperceptions by financial statement users. Lowe (1994), for example, finds that judges were uncertain as to financial statement responsibility (i.e., management versus auditor). Some judges also perceive the auditor's role as that of a public watchdog or guardian, to the extent of expecting the auditor to actively search for the smallest fraud. Pringle et al. (1990) find that the changed wording does not affect users' ability to determine investment attractiveness, and that the new wording actually makes it more difficult for users to decipher the intended message of the report. Geiger (1994) finds that users still are dissatisfied with the report despite the changes. In comparing the existing, shorter United Kingdom auditor's report to the new U.S. auditor's report,

Hatherly et al. (1991) and Brown et al. (1993) find that the SAS No. 58 auditor's report not only impacts user perceptions along dimensions included in the report, but also changes user perceptions about things not mentioned in the report, such as the company's lack of fraud. Hatherly et al. (1991) call this latter finding a "halo" effect.

Studies outside of the U.S. also confirm the lack of success in reducing the expectations gap. Monroe and Woodliff (1994), in an experimental survey of auditors, accountants, creditors, directors, shareholders, and students, find that the long-form report reduces the expectation gap in some areas, but increases it in others. The gap decreases in areas addressed by the wording changes, but actually increases in areas that are not the responsibility of the auditor, such as preventing fraud and assessing the future prospects of a company. An experiment by Innes et al. (1997) compares auditors and users provided with the short audit report with users provided with the expanded audit report. The expanded audit report closes the gap in areas associated with the audit process and audit environment, which were the main issues addressed by the expansion of the audit report. However, five dimensions not addressed by the expanded audit report move users' perceptions further away from that of the auditors. In particular, the perception that fraud was not present was statistically significant, suggesting further evidence of the "halo effect" noted in an earlier paper (Hatherly et al. 1991). Gay et al. (1998) perform an experiment across auditors, company secretaries, and shareholders comparing the review report to the expanded audit report. Significant differences between auditors and the user groups for the expanded audit report persist across all important aspects of the audit, including responsibilities, reliability, and decision usefulness.

In summary, extant research suggests that users attend to changes made by the SAS No. 58 auditors' reports. However, the new form of report leaves unchanged (and actually makes worse) many of the other misperceptions of users in relation to the audit expectation gap.

PCAOB Auditing Standard No. 5 Auditor's Report

As a result of the Sarbanes-Oxley Act of 2002 (SOX), audits of listed companies (issuers) must comply with audit standards promulgated by the PCAOB. Initially, the PCAOB adopted the existing set of ASB audit standards, but soon developed its own standard auditor's report, including elements related to the effectiveness of internal accounting control over financial reporting. Still, the PCAOB form of report does not appear to be a complete solution. In its *Final Report*, for example, the ACAP recommends that the PCAOB "undertake a standard setting initiative to consider improvements to the auditor's standard reporting model" (ACAP 2008, VII:13).

IAASB International Standard on Auditing 700 Auditor's Report

The fact that another form of audit report was proposed by the IAASB in 2003 and adopted internationally in 2006 provides further evidence that the expectation gap still exists. In the exposure draft issued by the IAASB for the proposed auditor's report, the stated objective is to "enhance understanding of the auditor's role and auditor's report" (IAASB 2003). The introduced changes include the following:

- a greater discussion on the auditor's responsibilities;
- a note that the auditor has complied with ethical requirements;
- a note that the audit evidence obtained is "sufficient and appropriate" to provide a basis for the audit opinion; and
- an explanation as to why the auditor evaluates internal control.

Chong and Pflugrath (2008) examine whether these most recent changes reduce the expectation gap between shareholders and auditors and, not surprisingly, find that it does not, consistent with the extant research on prior changes to the wording of standard auditors' reports. Their findings also

show more perception differences between these groups associated with the longer-form auditor's report, which also is consistent with expectation gap studies on the prior audit report (Monroe and Woodliff 1994; Innes et al. 1997).

Moving Away from Boilerplate

A review of literature on the auditor's reporting model by Church et al. (2008) suggests that additional information might enhance the auditor's report, but the value of any additions may diminish if the wording of the standard auditor's report remains "boilerplate." A report by the Audit Quality Forum (AQF 2007), from a survey of shareholders, comes to a similar conclusion. Shareholders believe the current audit report is "too boilerplate and overly standardized." Further, the AQF (2007) outlined the following as potentially being helpful to some shareholders:

- More information about emphasized matters and references to uncertainty and future risk;
- Discussion of any material issues encountered during the audit and their resolution;
- Tailored company reports, rather than standardized reports;
- Alternative accounting treatments considered and the reasons for adopting the treatment chosen, where material; and
- More information on material areas of judgment, and difficult or sensitive issues.

Church et al. (2008) suggest that research is warranted to improve the content of the auditor's report so users see something beyond simply a pass or fail signal. They also note that some studies evaluate the value of additional disclosures about materiality levels, as well as additional information about the auditor's findings (e.g., Manson and Zamon 2001). Church et al. (2008) call for further studies examining the effect of different disclosures in the auditor's report.

RESEARCH DESIGN

To elicit stakeholders' perceptions regarding the auditor's report, we conducted focus groups with five different stakeholder groups, including preparers of financial statements (CFOs), users of financial statements (bankers, financial analysts, and non-professional investors), and external auditors. The focus groups are an established methodology for exploratory research in the accounting profession. For example, the AICPA used focus groups to test its "Feed the Pig" public service announcements to improve financial literacy (Williamson 2007). Myers (2002) explains how CPAs could conduct focus groups to help align their services with the needs of their clients. The Public Oversight Board (POB) made extensive use of focus groups to gather insights for their major report, *The Panel on Audit Effectiveness Report and Recommendations*, commonly referred as the O'Malley Panel (POB 2000). The Internal Revenue Service (Shoemaker 2008), the General Accountancy Office (Crain and Bean 1998), and the Institute of Internal Auditors (Gray 2008) all use focus groups. During conversations with representatives at the IAASB and PCAOB, we found that group meetings for information gathering have been conducted having the characteristics of focus groups, but were not explicitly called focus groups. In contrast, an extensive literature search finds that academic research in the accounting and auditing domain rarely uses focus groups (e.g., Boritz 2005).

Focus group methods have evolved over 60 years out of research designed by Paul Lazarsfeld, Robert Merton, and their colleagues to gauge audience responses to propaganda during World War II (Kidd and Parshall 2000). The methodology is popular in the social and health sciences and in evaluation research. The intent of focus groups is to convey to policy makers the impact of changed policies perceived by individuals, groups, and organizations (Fitzpatrick and Boulton 1994).

The key characteristic of focus groups is the interaction and group dynamics of the participants. Focus group participants comment on and sometimes challenge each others' comments. Bristol and

Fern (1996) find that focus group participants perceived the focus groups as "more exciting and arousing" than participants in either surveys or structured interviews.

According to Fitzpatrick and Boulton (1994), focus groups are particularly useful where researchers want to identify a range of perspectives on issues among different stakeholders—for example, "bridging a gulf" in understanding between providers of a service and the intended users. The dynamics of a focus group are such that individuals' comments can "spark off" other participants to reveal broader insights than are possible from individual interviews. A major objective of focus groups is to identify areas of agreement and controversy to better understand how perspectives arise and are modified in a group (Carey and Smith 1994; Kidd and Parshall 2000; Reed and Payton 1997; Sim 1998).

Based on their use in other domains, focus groups seem to be a very appropriate way to explore the perceptions of the auditor's report by key stakeholders to assist in reducing the expectation gap. The following paragraphs describe preparations for the focus groups, facilitation of the groups, and the method used to synthesize focus group discussions.

Preparing for the Focus Groups

We conducted the first two steps of our research in parallel; namely, arranging the focus groups and preparing a focus group script. In keeping with the recommendation in focus group literature regarding homogenous groups, we planned for each category of stakeholder to meet separately. In addition, we scheduled the auditor focus groups after the other focus groups to solicit the auditors' reactions to the comments and suggestions of the other stakeholders.

We used a list of general questions in the ASB/IAASB RFP as a starting point for the script, which then was expanded to include questions based on our review of prior "expectation gap" literature and to include PCAOB-related questions. We then organized the final set of questions around the research themes presented earlier: overall perceptions regarding the audit and the auditor's report, perceptions regarding key concepts incorporated or potentially incorporated in the auditor's report, and suggestions and challenges for improving the auditor's report.

A script ensures coverage of all questions in each focus group, but the script must not be over-structured with too many questions. The purpose of the questions is to start discussions and then allow the interactions and discussions to run their course, and for the facilitator to ask unanticipated follow-up and probing questions.

As Table 1 indicates, a total of 53 individuals participated in the focus groups.[5] The original work plan was to conduct one focus group with each stakeholder group. However, we conducted two focus groups with CFOs and with auditors. The first CFO focus group was the pilot test for the script, and we conducted a second CFO focus group later in New York City. We also conducted two focus groups with auditors. We found it interesting that the auditors in the first focus group had some difficulty articulating the *intended* communications of the auditor's report, and debated among themselves about the relationship of level of assurance and materiality. As such, we conducted a second focus group with auditors from another major international accounting firm to expand on those discussions.

Facilitating the Focus Group Discussions

As each participant arrived, the facilitator noted that person's position on a seating chart.[6] The seating chart allowed the facilitator to use the person's name during the focus group, which would

[5] Having an unequal number of participants in each stakeholder group is not an issue, since we are not conducting statistical analysis of the qualitative results.

[6] The facilitator was one of the co-authors and has nearly 20 years of experience in conducting focus groups for professional organizations.

TABLE 1

Number and Sources of Focus Group Participants

Stakeholders	Number of Participants	Source
Financial statement preparers (CFOs)	15	Los Angeles and New York City Financial Executives International chapters
Bankers (lending officers)	9	Large anonymous international bank
Analysts	8	New York City CFA Institute Chapter
Non-professional investors	7	A Los Angeles investment club
External auditors (partners and managers)	14	Two large, anonymous international accounting firms
Total	53	

be important later for identifying each speaker when the facilitator listened to the recording of each focus group. At the beginning of each session, the facilitator discussed the objectives of the study and explained that participant comments would remain anonymous.

A focus group requires a mix of structure and spontaneity. During the focus groups, the facilitator used various techniques to encourage each participant's involvement and to ensure that there was no domination of the discussions by only a few participants. The facilitator conducted the first round of responses for each research question in round-robin fashion—alternating between proceeding in a clockwise and counter-clockwise direction for each question. However, since a critical aspect of the focus group is obtaining reactions from other participants, as each participant provided his or her initial comments to a question, before moving to the next person in the sequence, the facilitator asked the group if they had any responses to those comments.[7] The facilitator would also ask follow-up or probing questions before moving to the next question.

Generally, the facilitator let the discussions and interactions run their course. However, if any participant seemed to be taking too long with his or her comments, the facilitator would tactfully interrupt that person by asking the group if they had any reactions to the speaker's comments.[8]

The focus group with the non-professional investors started with the same script, but we adjusted the process slightly. These participants were members of an investment club that has been in existence for approximately 12 years, and represented a wide range of backgrounds. For example, one participant was a CPA who worked for a large financial institution. Another participant had a Ph.D. in psychology and was a marriage counselor. The members understood basic investment terminology such as EPS, beta, cash flow, and various financial ratios.

Since our research focused on the terminology in the auditor's report, with this group, we first concentrated on the words and phrases in auditors' reports, such as level of assurance and materiality, to explore how these non-professional investors interpreted those words and phrases. We then explored their reactions to the list of specific research questions in the ASB/IAASB RFP. We synthesized their comments with the other focus groups' comments.

[7] For a comprehensive discussion of all aspects of conducting focus groups, a good source is the "The Focus Group Kit" by Morgan and Krueger (1997).

[8] The facilitator would never interrupt a participant's initial comment to a question. In some groups, however, there sometimes may be a participant who wants to pontificate on everyone's comments, and that must be managed tactfully.

Debriefings and Focus Group Follow-Ups

Near the end of each focus group, the facilitator thanked the participants and encouraged them to contact him with additional comments. Follow-up emails to the participants again thanked them for their participation and encouraged them to send any additional comments. In addition, we contacted some participants directly to clarify some point they made during the focus groups.

Synthesizing the Focus Group Discussions

Synthesis of focus group recordings is an iterative process transcribing each recording. After transcribing all recordings, the actual synthesis process begins to create one comprehensive focus group document. The draft synthesized document involved several rounds of reviews with the researchers concerning editing and clarifying the discussions.

RESULTS

The following is a synthesis of the discussions from the seven focus groups. We organize the discussion around the three research themes.

Theme 1: Overall Perceptions Regarding the Audit and the Auditor's Report

The purpose of the discussion questions related to Theme 1 was to obtain perceptions regarding the financial statement audit and the auditor's report taken as a whole. The key points that came out of Theme 1 discussions were as follows:

- Stakeholders value the audit, but they cannot assign a measurable value to the audit.
- Users consider the auditor's report to be "boilerplate" and typically do not read the auditor's report, and auditors do not expect that they do.
- There was a consensus that, conceptually, a replacement for the current unqualified auditor's report could be a stamp that said "O.K.," along with the standards used by the auditor and the name of the firm that conducted the audit.
- Users look to see if the report includes an unqualified opinion and whether a Big 4 firm conducted the audit. If yes on both counts, that is the last time they look at the report. If a Big 4 firm did not conduct the audit, the user *may* do some research to determine the reputation of the firm signing the auditor's report.[9]
- An unqualified auditor's report does not imply anything about the quality of management or whether the company is a good investment (unless the auditor's report includes a going-concern opinion).

One participant stated that one reason it is difficult to place a value on the audit is that the financial statements with the auditor's report is one package, and it is the package that has value—not the two separate parts in isolation. As one banker said, "[Unaudited] financial statements would just be junk." Participants in the different groups also frequently stressed the point that an audit is a compliance issue that has to be done whether it has value or not.

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 report indicates the financial statements are presented fairly according to generally accepted accounting principles. A third auditor suggested the report is a "legal liability-releasing" document for the auditor, but it is not as effective in releasing

[9] See Gray and Ratzinger (2010) for an in-depth discussion of stakeholders' perceptions regarding financial statement audits conducted by Big 4 accounting firms.

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 his/her responsibilities and describes the auditor's conclusion. He said, "At its heart, the auditor's report is something written by attorneys to limit or release liability."

The non-professional investors indicated that the audit is important, but they assume the auditor performed the audit properly and the companies they would consider for their portfolio "passed" the audit. In addition to not reading the auditor's report, the investors said they never use the financial statements in annual reports, 10-Ks, or 10-Qs published by the companies. Instead, they relied on secondary sources, such as *The Value Line Investment Survey* or the Motley Fool and similar websites. This reliance on secondary sources was not a naïve decision on their part. They belong to the National Association of Investment Clubs (NAIC), and the NAIC guidelines recommend using a variety of financial ratios quickly extracted from secondary sources. In addition, these secondary sources provide buy/sell/hold recommendations regarding the companies, which are important inputs to their investment decisions.

Focus group participants' observations regarding the standardized "nobody-reads-it" aspect of the auditor's report support findings of prior research, such as the Church et al. (2008) comments regarding the auditor's report being a "certificate." Even the auditors agreed, conceptually, that an "O.K." stamp could replace the current auditor's report.

A disconcerting aspect of the Theme 1 discussions is that no apparent progress has been made since the Cohen Commission expressed its concerns that standardized language made the auditor's report a "symbol" not carefully read (Cohen Commission 1978). In other words, it appears that SAS No. 58, PCAOB Audit Standard 5, and ISA 700 simply have replaced one set of boilerplate content in prior unqualified auditors' reports with another set of boilerplate-based auditors' reports.

Theme 2: Perceptions Regarding Key Concepts Incorporated or That Could Be Incorporated in the Current Auditor's Report

After discussing the overall perceptions of the audit and the auditor's report under Theme 1, the focus group discussions shifted to the specific concepts included (or potentially implied) in the auditor's report, including level of assurance, materiality, sampling, internal controls, fraud, and going-concern. The key points that came out of Theme 2 discussions follow:

- In the abstract, users know auditors do not provide absolute assurance. But the concepts of *level of assurance*, *reasonable assurance*, and *high level of assurance* are fuzzy to all the stakeholders, including the auditors.
- To varying degrees, users link the concept of level of assurance with that of materiality. Some stakeholders, including a number of auditors, believe the two concepts are strongly linked (they are "equal").
- Users have a basic understanding of materiality and sampling, but their assumptions as to materiality levels and sample size differ considerably.
- If the auditor's report is silent on fraud and going-concern, users believe auditors tested these two issues thoroughly and there were no problems.
- Users do not believe that in conducting an ASB-based audit, auditors are forming an opinion on the internal accounting controls.
- Most preparers, users, and auditors in the focus groups believe a PCAOB-based audit, with its explicit requirement for an internal control opinion, is superior to an ASB-based audit. Preparers and users believe the PCAOB audits are more thorough. Auditors believe the numbers the client gives them are better, because the client worries that "bad" numbers will lead to a negative opinion on the internal controls.

Below, we further elaborate on some of the specific discussions from focus group participants.

Level of Assurance and Materiality

The focus group script had separate questions regarding level of assurance and materiality; however, the discussions of these two concepts quickly blended together. One of the main concerns leading to issuance of SAS No. 58 in 1988 was that users exhibited apparent misperceptions regarding the intended level of assurance. A study commissioned by the IAASB found a great deal of variability in perceived levels of assurance, even among the assurance providers themselves (Hasan et al. 2005). More than 20 years after issuance of SAS No. 58, the ASB and IAASB still have concerns that some users believe the audit provides absolute assurance (AICPA/IAASB 2006). The PCAOB has similar concerns (PCAOB 2010).

The second sentence of the second paragraph in the SAS No. 58 auditor's report covers both the level of assurance and materiality. This paragraph says, in part, "we plan and perform the audit to obtain *reasonable assurance* about whether the financial statements are free of *material misstatement*" (emphasis added). Focus group participants seem to have a basic understanding of reasonable assurance in that none of the participants, including the non-professional investors, believes an audit provides absolute assurance. However, the participants did frequently express a concern that there are financial statement users—other than themselves—who likely do believe that audits provide absolute assurance.

Even though the participants did not believe that auditors provided absolute assurance, level of assurance is still a fuzzy concept to the participants—even to the auditors. This fuzziness is understandable, since the audit standards do not operationalize or quantify reasonable assurance. SAS No. 1 (AICPA 1972), Paragraph .02, introduces reasonable assurance: "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance." SAS No. 104, Amendment to Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures*, has four paragraphs (AICPA 2006, paras. .10–.13) that discuss reasonable assurance in more detail. Paragraph .10 indicates that reasonable assurance is high assurance. However, similar to the meaning of "reasonable" in SAS No. 1, SAS No. 104 does not define, quantify, or operationalize high assurance.

Across all the focus groups, participants thought level of assurance and materiality are closely related, but there were debates as to exactly how they are related. Many auditors expressed a belief that the level of assurance and materiality are essentially the same thing, but other auditors strongly disagreed. However, auditors who disagreed had a difficult time trying to explain how the two concepts differ.

Some participants view materiality as a surrogate or indicator for level of assurance. For example, all else being equal, users would feel they are receiving a higher level of assurance where materiality was 1 percent of assets versus an audit where materiality was 2 percent of assets. The 1 percent materiality level would require more audit work, increasing the likelihood of finding errors and fraud. Therefore, users would have more confidence—a higher level of assurance—in those financial statements.

Although materiality may be more quantifiable than level of assurance, financial statement user groups had very diverse perceptions regarding the concept of materiality. Some users, particularly the non-professional investors, were very surprised that materiality levels can be millions of dollars for large companies. CFOs seemed to have the best understanding of materiality because most had prior experience working as Big N auditors.

Sampling

All participants understood that auditors use sampling as part of the audit. However, as with materiality, auditors do not disclose sample sizes, and users' perceptions regarding sampling varied widely. Non-professional investors thought sample sizes are much larger than those typically used

by auditors—one investor thought sample sizes are 20 percent to 30 percent of an account balance or more. Some participants thought sampling is more "scientific" than the judgmental methods auditors frequently use. One banker said the auditors use "actuarial tables" when selecting sample sizes, and he was very disappointed when the facilitator said that auditors use non-statistical sampling far more frequently than statistical sampling.[10]

Internal Controls and Internal Control Audits

One significant difference between ASB and PCAOB audit standards is that PCAOB standards require the auditor to express a separate opinion on the client's internal control over financial reporting (ICFR). Participants generally indicated they do not assume an SAS No. 58 auditor's report implies anything about the quality of the internal controls. In fact, the bankers indicated they sometimes conduct their own internal control review of those parts of a company seeking a loan, such as controls over pledged accounts receivables.

In general, the CFOs believe that PCAOB-based audits are superior to ASB-based audits, and one CFO indicated that an unqualified opinion on ICFR increases his confidence in the financial statements. He said SOX Section 404 activities have increased significantly the amount of time auditors are at his company, and the audit requires more documentation, more testing, more rigorous audit procedures, and the participation of more people. Analysts, in general, thought the ICFR opinion provides additional information, including insights into corporate governance.

One auditor mentioned that he believed the initial financial statement numbers presented to the auditors by their clients are now more accurate under PCAOB-based audits, because the client knows that any adjustment may result in adverse opinions regarding ICFR. However, another auditor expressed a concern that private companies typically have weaker internal controls, particularly with segregation of duties. In such cases, internal control audits for private companies would always have some negative aspects to them, and the value of these negative reports to financial statement users was unclear.

Fraud

An unqualified auditor's report does not explicitly say anything about fraud. The participants, however, assume auditors looked for fraud and found none. In addition, some auditors voiced concern that a number of users believe the level of assurance or materiality level applied to the overall audit also applies to fraud testing. According to the participating auditors, fraud testing is not subject to the same level of assurance or materiality level as are other aspects of an audit.

Going-Concern

There was a general consensus among participants that a going-concern opinion provides important information to financial statement users. User groups assumed that if the auditor's report does not include a going-concern comment, the auditors performed an adequate going-concern analysis and concluded going-concern was not an issue. However, there were differences in perception between the auditor groups and the user groups as to the degree of analysis performed by the auditors. Auditors stressed their going-concern analyses consist primarily of forecasting cash flows and other key financial data for one year to determine if the company has sufficient liquidity to operate through the next year. The auditors do not evaluate management, the company's business model, or the quality or competitiveness of company products as part of their going-concern

[10] According to Hall et al. (2002), auditors in their survey used non-statistical sample selection methods for 85 percent of all audits.

analysis. In other words, unlike the users' perceptions, auditors do not perform an analysis that a Wall Street financial analyst might perform to determine if a company is a good investment.

Theme 3: Suggestions and Challenges for Improving the Communication of the Auditor's Report

Asking participants to suggest ways to improve the auditor's report created the most polarizing part of the focus groups. As reflected in the Theme 1 summary, there was strong consensus that a stamp simply saying "O.K." could replace the current unqualified auditor's report. However, the Theme 2 discussions of the detailed language of the auditor's report showed that significant differences in perceptions exist, and even auditors had difficulty defining and agreeing on the *intended* communications of the auditor's report. When it came to discussing recommendations to potentially improve the auditor's report, there were more spirited discussions of the pros and cons of each recommendation. Table 2 summarizes those recommendations, rationales for the recommendations, and the concerns associated with the recommendations. The following paragraphs detail the key points captured in Table 2.

Include the Auditor's Signature

IAASB audit standards allow the engagement auditor partner to sign the auditor's report with his or her name in addition to the firm's name, and some jurisdictions actually require the partner to sign the auditor's report in that manner.[11] Responding to that idea, one CFO said, "Since I'm paying a lot of money to the firm, I would rather see [just] the firm's name on the auditor's report." Another CFO did not like the idea for three reasons. First, the audit is the accumulated work of many people, and users are relying on the reputation of the firm. Second, what is the impact if the specific audit partner was well recognized in the profession, but retires, and a junior partner takes over the audit? Will that have a negative impact in the financial markets? Third, if a partner signs the auditor's report, then the auditor will want to do more audit work because his/her personal reputation is on the line. Another CFO pointed out that if it added prestige to the audit to have the firm's industry expert sign the auditor's report, the expert's signature would end up appearing on every auditor's report for that particular industry, so then there would be a concern as to how much time that partner was actually dedicating to each audit. Because of the demand for these "star" partners, the hourly rate of these partners probably would increase significantly.

The bankers also had a mixed reaction to this idea. Some bankers already have a close working relationship with the client and the CPA firm conducting the audit, so they frequently know who the auditor partner is for a specific borrower. Other bankers thought it would be useful information as a contact point if they had follow-up questions. Another banker thought having the auditor's name on the report would improve the perception of audit quality.

One analyst said his colleagues discussed the idea of the audit partner signing the auditor's report, and generally agreed they would have more comfort with the audit if the partner signed the report. However, another analyst argued that if the partner signed the report, the report would become even more boilerplate because the auditor would want to make sure there was absolutely nothing controversial or exceptional in the report. In terms of the value of a well-known partner signing the report, the analysts did not appear to have a strong opinion, either positive or negative. Like the CFO's concern, the analysts raised the concern that if the star partner was signing

[11] A discussion regarding the engagement partner's signature appeared in the U.S. Treasury's Advisory Committee on the Auditing Profession (ACAP) *Final Report* (ACAP 2008). Specifically, Recommendation 6 (ACAP 2008, VII:19) states: "Urge the PCAOB to undertake a standard-setting initiative to consider mandating the engagement partner's signature on the auditor's report."

TABLE 2

Changes to the Auditor's Report Suggested by Participants

Recommendation	Rationale	Concerns
Include engagement partner's signature on the auditor's report in addition to the firm's signature.	Would improve quality of audit because the engagement partner would take explicit responsibility for the report. Already practiced and required in some countries (e.g., Germany, Sweden, and Finland).	It is the audit firm's resources, practices, and standards applied to the audit, so only its name should appear. It does not change the engagement partner's responsibility because he/she signs off on the audit internally.
Say something explicit about fraud and internal control testing.	Manage users' perceptions concerning fraud and internal control testing.	More disclosures will mean higher audit fees.
Attach management letter.	Already required by some third parties. It already exists; therefore, it is a "free good." It provides useful internal control information. It will disclose the parts of financial reporting on which management is focusing.	Auditors may want to do additional auditing of anything disclosed in the letter. The management letter may be cleansed through negotiations between the client and the auditor before distribution. Negative comments about the client's internal controls may negatively affect the client, but have little to do with the quality of the audited financial statements.
Disclose materiality levels and sampling information.	By definition, users can be expected to misinterpret what the auditor's report is communicating if fundamental audit parameters are not explicitly disclosed.	If these parameters are disclosed, clients will try to game the system and may shop for auditors who use higher materiality levels and smaller sample sizes. To control auditor risk, the auditors will audit to even tighter parameters so they have full confidence that the disclosed parameters are achieved. Materiality is more than just a number; it has a qualitative aspect to it.
Add granularity to the audit by providing "grades" to an unqualified opinion, or by giving separate opinions on key elements of the financial reports.	Provides users with more information about the client. For example, did they pass the audit with flying colors (received an A), or did they just barely achieve an unqualified opinion (received a C).	May require more auditing. How would users interpret different grades from a Big 4 versus a non-Big 4 audit firm? How would users interpret different grades from one year to the next?

(continued on next page)

TABLE 2 (continued)

Recommendation	Rationale	Concerns
Add information that describes audit planning and subsequent discussions with management.	Would improve users' understanding of how the auditors arrived at their opinion. Much of this is now explicitly required in SAS No. 114.	Would drive up audit costs.

numerous audit reports, then how much time is the partner spending on each client's audit. However, some did see some value in having a senior-level person associated with a particular audit.

Although one auditor thought the idea would increase his reputation, the majority of the auditors did not support this idea. Signing the auditor's report does not change their responsibility or liability because they already sign off internally on the audit. One auditor expressed concerns about the privacy issue associated with the partner's name on the report. Another auditor said a team following firm procedures and standards performs the audit, so it is appropriate that the report include just the firm's name.

The auditors did not believe that having the firm's industry specialist signature on the auditor's report would significantly improve the audit, but they were concerned users might believe that audit was somehow superior. The auditors also were concerned that it would spread a "star" auditor too thinly to assign him or her to all audits requested by clients. In addition, star auditors probably could demand a higher hourly rate. The method of assigning newer, less famous partners to audits also was a concern of the auditors.

Say More about Internal Controls in ASB-Based Auditor's Report

Some participants suggested the ASB-based auditor's report should include the audit team's conclusion about their ability to rely on the client's internal controls, their control risk assessment, and how they designed their audit procedures based on that assessment. The participants wanted to know the context by which the audit team established its audit procedures and test work. For public companies, the PCAOB requires extensive communications with the audit committee, including identification of critical audit areas, the degree of reliance on internal control, and issues that surfaced during the audit. For non-public companies, focus group participants suggested the AICPA adopt similar reporting standards.[12]

Say Something Explicit about Fraud

As mentioned earlier, if there is no mention of fraud in the auditor's report, all nonauditor participants assume the auditors looked for fraud and none was identified. To prevent misinterpretations regarding fraud, some nonauditor participants suggested the auditor's report

[12] Although the auditor's report in SAS No. 58 is silent on internal control, a later interpretation, *AU 9508 Reports on Audited Financial Statements: Auditing Interpretations of Section 508* (AICPA 2008b), indicates an auditor may add language to the auditor's report regarding their limited internal control procedures. The suggested sentence to include in the first paragraph is, "An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion."

should include a specific statement regarding fraud.[13] An auditor also suggested the auditor's report should say something about fraud because the public believes the auditor's job is to detect fraud. Another auditor added that there needs to be stronger language regarding the limits of the audit and the subjective nature of the financial statements. However, another auditor had a contrary view and said that even if the auditor's report was 20 pages long with stronger language, if the client fails, the auditors are going to be sued for that failure.

One auditor suggested the "radical idea" that reviewing the last three years of client emails should be a required part of each audit. This would be better at ferreting out fraud than SOX-related activities. He based this suggestion on the comments he received from the fraud and forensic specialists within his firm who say the "skeletons" are always in the emails.

Attach the Management Letter to the Auditor's Report

Although the exact requirements and suggested wording vary, SAS No. 115 (AICPA 2008a), AS 5 (PCAOB 2007), and ISA 700 (IAASB 2010) each require the auditor to communicate in writing, to management and individuals charged with governance, any significant internal control deficiencies or material weaknesses identified during the audit. At least one participant in each focus group raised the idea of including this written communication (referred to herein as the *management letter*) with the auditor's report.[14] This suggestion initially seemed to be a "free good," since the audit firm already provides this material to its clients when appropriate. Some CFOs said that various third parties already require auditors to submit the management letter along with the auditor's report. The bankers confirmed they do sometimes request the management letter if internal control is important to the underlying loan (e.g., accounts receivable is pledged as collateral for the loan).

The distribution of management letters to recipients other than the audit client raised the question of whether the letters would go through a "cleaning" process, where management asks the auditor to remove, change, or tone down some comments. Nevertheless, as one analyst said, even if the final contents of the management letter were "negotiated," it still would be better than no management letter because it would indicate areas management is currently working to improve.

On the downside, an auditor said that management letters could be particularly sensitive issues for private companies because a management letter may include comments that may be embarrassing to the client, but have nothing to do with the audit opinion on the financial statements. The auditor gave an example: "What if the accounting department is understaffed? The auditor can compensate for this in their audit procedures, but how will users of the financial statements interpret a comment in the management letter suggesting the accounting department could use a tax expert or additional higher-level accounting types?"

Disclose Materiality

If standard setters want financial statement users to interpret correctly the levels of assurance provided by the auditor's report, it is clear from the Theme 2 discussions that some changes to the auditor's report are needed. Since participants expressed a connection between level of assurance

[13] The expanded ISA 700 report does state, "The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error" (IAASB 2010).

[14] We recognize that management letters predate the aforementioned audit standards and can include more than communications regarding the internal controls, but the participants commonly use the term *management letter* to be all-encompassing, and in their discussions did not distinguish between the *required* communications on internal controls and traditional management letters. As seen in the discussion, when participants talked about management letters, they were addressing the internal control reporting aspects of the communication.

and materiality, disclosing materiality may be a significant step toward closing the expectation gap regarding level of assurance.

Preparer and user comments about disclosing materiality. A minority of CFOs thought it was a good idea for auditors to disclose materiality information, arguing more information is better than less information. Most CFOs, however, expressed concerns about how disclosure of materiality would change the auditor's risk profile and increase audit fees. As one CFO indicated, the auditor's report has evolved to its current state of being subject to reviews by the courts for many years, and any changes to the report may change the auditor's litigation risk.

Some CFOs stated it is going to be impossible to agree on a common definition of materiality because each accounting firm has a different definition of materiality, and materiality also includes a qualitative aspect that goes beyond reporting materiality numbers (e.g., 1 percent of revenue). One CFO said, "It is a slippery slope—you're going to end up with a 16-page auditor's report." Another CFO said, as a practical matter, people may not understand why the numbers are different for different companies. Another CFO added that disclosure of materiality levels in the auditor's report would require some standardization to reduce any confusion resulting from companies using different percentages (1 percent, 2 percent, etc.) and/or different bases (revenue, net income, assets, etc.) to calculate materiality.

One concern voiced by a banker was that additional information would "just get in the way." He also felt that bankers—instead of auditors—would start setting materiality levels. Another banker said users either feel comfortable with the financial statements as currently presented or they do not, and the disclosed materiality level will have little or nothing to do with that comfort level. Similar to the CFO comment above, a banker pointed out that someone (i.e., standard setters) would have to include benchmark information so users would know if the auditor was varying from typical practices. The bankers believed auditors would view these additional disclosures as increasing their risk and, therefore, would want to conduct additional audit work, resulting in an increase in the audit fees.

An analyst said her colleagues frequently have asked why auditors do not disclose the materiality level so the analysts could decide whether that level is adequate for their analysis. Some analysts in the focus group thought this disclosure was a good idea. One analyst, however, expressed a concern that companies would try to "game the system" and, for example, keep any fraudulent activities below the disclosed materiality level. Another analyst said having more information, including materiality levels, might be good, but it is not a substitute for the analysts asking more questions of management. In other words, audited financial statements are the starting point of their analysis that, subsequently, will generate follow-up questions for the company's management.

Auditors' comments about disclosing materiality. Similar to an analyst's comments above, a concern expressed by some auditors was that some clients would try to "game the system." Another concern was that companies would gravitate toward auditors who use the highest materiality levels. Another auditor added that disclosing materiality levels would work only if the AICPA and the PCAOB set materiality standards and required a footnote such as "the materiality level was 2 percent of assets, in accordance with AICPA or PCAOB standards." Another auditor added that there could not be just one materiality standard because for some clients, assets make the better base, but revenue would be a better base for other clients. Another auditor said it is going to confuse the users if they try to compare one company whose materiality was based on assets and another company whose materiality was based on revenue. Another auditor commented that if the auditor includes one materiality level in the auditor's report, the user is going to assume every line item on each financial statement was tested to the same materiality level, which is not true.

One auditor said at the beginning of the audit that there is a default value for materiality, but as the audit progresses, there are qualitative and subjective aspects that also are associated with

materiality. The auditor said significant professional judgment is associated with materiality numbers. As such, disclosing materiality numbers alone does not capture the full concept of materiality. Accompanying materiality disclosures would be an explanation as to what the materiality level was, and why there were any adjustments for things such as debt covenants or fraud matters.

One auditor said he liked the idea of disclosing materiality, and suggested the auditor could add another paragraph to the auditor's report that provided materiality information. However, he asked that if the disclosure said, "in our opinion, the accompanying income statement could be off by $20 million, which we would not consider material," how would that information change the views of the users of the financial statements?

Another auditor said that audit standards would have to provide guidance as to what the materiality numbers should be, and that the trend probably would be to decrease the materiality levels below that guidance just to be safe or conservative. A third auditor agreed that the reported materiality levels probably would decrease, and the auditor likely would use a still-lower internal materiality level for their audit work, which would increase audit work and fees.

Echoing these points, a fourth auditor expressed a concern that users of financial statements would not really know what to do with materiality disclosures. Other auditors agreed that it would be necessary to provide some form of education so users would know what materiality numbers mean.

Managing expectations. Regarding the disclosure of materiality, one auditor provided an interesting analogy. Public companies now provide guidance on key items, such as earnings per share, as to what they expect future results to be. One auditor asked an audit client why the client company discloses those numbers, since there is risk associated with making such projections. The client said it was for defensive purposes, because if the company did not disclose the numbers, analysts would publish their own projections. By publishing its own projections, the company is managing the marketplace's expectations. Participants made the point several times during the focus groups that financial statement users have unrealistic expectations in terms of auditing to the penny, very tight materiality levels, and very large sample sizes. As such, if the auditors disclosed this information, the auditors then would be helping manage the financial statement users' expectations regarding the audit and, thus, likely lowering the expectation gap.

Add Granularity to the Auditor's Report

One CFO suggested providing a grading scheme (e.g., A, B, and C) to the unqualified auditor's report instead of merely pass/fail. Most of the CFOs seemed opposed to this idea and raised several concerns. What do those grades mean and how will they change the auditor's risk profile? What would the auditor's liability be if the client received an A one year and a C the next year, and the client's stock price or bond rating dropped due to this grade change? How does the financial statement user compare a B from a Big 4 accounting firm to an A from a third-tier accounting firm?

Another CFO suggested a different form of granularity—divide the audit into five to ten different elements and have the auditor provide a rating or opinion on each of those elements as part of the overall audit opinion. Some elements could be management, revenue, and cost structure. However, another CFO argued such granularity may be going too far beyond the purpose of the audit, which he suggested is to have an opinion on the accuracy of the financial statements.

A CFO pointed out that much of that granular information is in the footnotes already and in other parts of the 10-K and annual report, and the auditor's report already indicates all that material is accurate. However, another CFO argued that it is not obvious where that information can be found, and it would be useful if a summary of parameters particularly applicable to an industry was in one location. Then, 10-K users would know the assumptions made by the company regarding

estimates and valuations. Another CFO said it also would be useful to have a summary of the top five risks in one place.

Add Footnotes or a Synopsis to the Auditor's Report

A number of participants said they would like more information on how auditors reached their opinions, or a synopsis of discussions between the auditors, client management, and the audit committee, and the outcome of those discussions. These suggestions would appear to be a paradigm shift in terms of the relationships between the auditors, those charged with governance, current investors, and the public at large. Currently, some audit information is proprietary and only shared among the auditors, and some information is shared with only top management and the audit committee. The only information auditors share with current investors and the public is the carefully worded auditor's report. The suggestions below from the focus group participants would make publicly available some proprietary information and information provided to those charged with governance. As the discussion illustrates, besides changing the risk profile for the auditors, such disclosures would change significantly the role of the auditor's report in the financial statement analysis process. The unqualified auditor's report would be much more than just a certificate of completion easily replaced with a simple "O.K." stamp.

One banker suggested that auditors disclose "highlights" of anything thought to be a significant change for the company, whether the client disclosed that change or not. The change could be a presentation change or a change in the numbers. Even if the client disclosed the changes in the financial statement notes, if the auditor thought it was significant, the auditor should mention it in his or her disclosures. Another banker said, "More transparency is better." However, another banker argued that if the client's footnotes accompanying the financial statements are adequate, the auditor would not need a separate disclosure—the onus is on the auditor to ensure the client's disclosures are adequate. One analyst said he would prefer that the company just put all its footnotes about accounts with estimates in one place and explain the impact or sensitivity of those judgments. Another analyst said analysts also would like a similar discussion regarding client estimates from the auditor. For example, what did the auditor propose to the client as adjustments, why did the auditor propose those adjustments, and if they were rejected by the client, why were they rejected?

Another banker argued against any additional auditor "highlights." Currently, he makes a quick check of the auditor's report, and if it was an unqualified report, he moves on to the financial statement footnotes. He does not want to have to study a lot of additional details in the auditor's report and then study the financial statement footnotes.

An analyst mentioned that a Chartered Financial Analyst (CFA) survey indicates 84 percent of analysts would like this risk information included with the auditor's report.[15] One analyst expressed a concern that any item in an auditor synopsis probably would require 30 minutes of discussion on the analyst conference call and, in such an event, the company would want to manage the auditor synopsis carefully. The analyst's concern led to a discussion as to whether there should be a standardized synopsis discussing the same risks for every company. Some analysts believed a standardized synopsis would help them make year-to-year and company-to-company comparisons. However, other analysts said they would prefer to get a company-specific synopsis to help them focus their analysis of that company. An analyst said a customized report would be particularly useful for diversified companies by indicating where risks may have shifted between subsidiaries.

One analyst arguing for a synopsis used an analogy: What would you prefer—knowing that a bond rating analyst rated a company's bond A3, or why the bond rating analyst rated the bond A3? Arguing the other side, one analyst was concerned the clients would try to "game the system" by

[15] Available at: http://www.cfainstitute.org/Survey/independent_auditors_report_poll_results_march_2008.pdf

conducting fraudulent activities outside the risk areas mentioned in the auditor's synopsis. She also expressed concern that new disclosures eventually would also become boilerplate, and "your eyes would glaze over reading all that material." Another analyst compared this additional information to the comfort letter some underwriters request. She added she was not sure of the value of seeing a 20-page explanation of all the steps the auditor took to conduct the audit. A third analyst said what they want to see are the exceptions—changes to the audit approach, adjustments that the client made or did not make, and exceptions to standards.

One auditor opined that the auditor footnotes or synopsis would be like the auditor having his or her own auditor discussion and analysis of the audit, similar to the management discussion and analysis that may accompany the financial statements. Another auditor said a synopsis would be somewhat like the due diligence reports they prepare for specific, nonaudit engagements summarizing the firm's procedures and conclusions. An auditor suggested that audit costs would increase substantially because hundreds of hours would go into drafting and evaluating these additional reports. It probably would trigger more-thorough audit procedures of anything in the report, and there would be dedicated staff just to review those reports. The general counsel probably would review every report. Another auditor noted that, currently, all financial statements are the responsibility of company management, and only the opinion comes from the auditor. Packaging an auditor summary report with the financial statements would change the auditor's risk profile significantly. A few participants noted that some of these additional auditor disclosures already are included in the material presented to those charged with governance by the auditors, so the real question may be: What information presented to those charged with governance should also be disclosed to the public?

Another auditor said she did not know how this summary, which would be so "cleaned up," would give the user any additional useful information for their analysis. Another auditor added, "less is more." That is, because the current auditor's report is short, any additional information, such as a going-concern opinion, emphasis of a matter, etc., included in the auditor's report, is going to be evident to the user. On the other hand, if the auditor's report included significant additional materials, then these issues would be lost in the details.

CONCLUSIONS

The current SAS No. 58 standard unqualified auditor's report has been in place for over 20 years. Both prior research and our results indicate the expectation gap is still significant. The focus group approach provides some new perspectives on the expectation gap, as well as some support for findings from other research methods.

One critical finding of our research is the lack of consensus as to what is the *intended* communication of the auditor's report. Even the participating auditors have difficulty describing and agreeing on the intended communication of the auditor's report. The stakeholders provided rich discussions on their perceptions regarding the auditor's report concepts, their experiences on using the reports, and their suggestions about possible improvements to the reports. The stakeholders also provided concerns associated with those suggestions.

Currently, auditors do not disclose materiality levels and sample sizes publicly, do not quantify the level of assurance, and the auditor's report is silent on some aspects of the audit, such as fraud. Thus, as the Theme 2 discussion illustrated, users' perceptions of what the auditor's report is communicating are very likely to be flawed—and sometimes, like the comments from the non-professional investors, the perceptions are far from reality.

Directions for Future Research

The research presented in this paper raises many interesting and provocative ideas, concerns, and suggestions. The next logical steps in future research fall into two broad categories, the first of

which is behavioral. Each of the suggestions to change the auditor's report has associated risks; therefore, as the participants stressed, none of these suggestions are "free goods" without potential consequences. As such, rigorous research must determine if or how implementation of each suggestion might change behaviors within each stakeholder group. If behaviors did change, would the changes be positive or negative? For example, would the precision of the numbers provided by the preparers change in relation to the disclosed materiality levels? Preparers may use materiality levels as their own precision targets, as they may believe there is no reason to be more precise than the auditors. Will auditors, as the participant auditors speculated, set their actual materiality levels lower than their "disclosed" levels, and do more audit procedures to increase their confidence that they achieved the disclosed materiality levels? Importantly, would disclosure impact users' analysis of financial statements? If the answer to this last question is no, then it does not warrant adding the efforts, regulatory actions, and risks associated with materiality disclosures.[16]

A second category of future research would focus on the cost-benefit aspects of each suggestion. It is not enough that stakeholder behaviors change—researchers should examine the economic consequences of the suggestions. In general, a suggestion should have positive societal results. However, sharing of benefits and costs by various stakeholders offers a more problematic, and possibly more interesting, research question. For example, what if the analysis indicates a suggestion will provide a net benefit to users, but a net cost to preparers and auditors? Is the change justified if it is a burden to one or more stakeholders? Should, or how should, costs be shifted between stakeholders to make the economic impact "more equitable"?

Another perspective for researching the audit reporting model would be to apply institutional theory (from organizational behavior literature) that can provide a more comprehensive view of the interactions between different parties (i.e., various stakeholders) than the traditional agency literature used in auditing and accounting research. For example, Cohen et al. (2008) and Beasley et al. (2009) have recently explored the application of institutional theory to the audit domain. As our research and prior audit reporting literature have shown, the auditor's report has become more form than substance—it is boilerplate. Institutional theory designates this movement toward boilerplate as coercive isomorphism. The bankers and analysts, in particular, in our study have clearly indicated that no matter how much additional content is added to the auditor's report, they will still not read the report if the additional content is just more boilerplate. The application of institutional theory could offer new insights into the audit report model and help develop future improvements to the auditor's report.

Examination of potential modifications to the audit reporting process is not only rich in possibilities, but the results of rigorous academic research can provide insights directly impacting the audit profession. Such research can result in a stronger bond between academia and practicing auditors and prove invaluable to both groups.

Beyond audit reporting model, future research also should consider additional applications of the focus group method. Exploration of policy-related issues is a strength of the focus group approach, and both accounting and auditing domains face many pending policy issues. Academics could use focus groups to help identify policy issues and the scope and strengths of opinions among various stakeholder groups regarding those issues. Focus groups provide deeper insights into stakeholders' perceptions. The contemporaneous interactions of the focus group participants and the opportunity to ask the participants follow-up and probing—and sometime argumentative—

[16] Coram et al. (2011), which reports on the second part of our funded research project, used verbal protocol analysis (VPA) to explore financial analysts' behaviors regarding the auditor's report. While the analysts attended to the auditor's report, they did not change their initial public offering (IPO) price for a company, whether the company's financial statements were accompanied by the auditor's report or not.

questions provided a wide variety of findings regarding policy issues. Focus groups can provide findings that would be difficult to discover with other research techniques.

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