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A Framework for Extended Audit Reporting

Final Report

Research project commissioned by
Association of Chartered Certified Accountants (ACCA)

executed by

Maastricht Accounting, Auditing and Information Management Research Center (MARC)

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Preface

This report presents the results of a research project on a framework for extended audit reporting. The project was commissioned by ACCA (the Association of Chartered Certified Accountants), which is the global body for professional accountants. Through its public interest remit, ACCA promotes the appropriate regulation of accounting and conducts relevant research to ensure that the reputation and influence of the accountancy profession continues to grow, proving its public value in society.

This research project was conducted by the Maastricht Accounting, Auditing and Information Management Research Center (MARC) of Maastricht University. MARC has final editorial responsibility for this report. Therefore, the conclusions and recommendations of this report are not necessarily shared by ACCA.

The research team would like to express its gratitude to the auditors, investment bankers, financial and credit analysts who participated in this study. Their contribution to this project, including many critical remarks and discussions, was of significant importance for the research team to formulate their proposals. We would also like to thank academic colleagues for their suggestions including Jean C. Bedard, Glen Gray, Ted Mock, W. Robert Knechel, and Roger Simnett.

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Executive summary

MARC has been commissioned by ACCA to perform a study on extended audit reporting. In particular, MARC has been asked to: (1) develop a framework for extended audit reporting based on a review of the literature on possible additional disclosures in the audit report and possible audit reporting formats; and (2) validate this framework based on discussions with a limited number of stakeholders (users and auditors) to develop an agenda for future research.

After reviewing academic and professional literature on audit reporting, we classify potential additional disclosures in the audit report into five categories: (1) clarification of the scope of the financial statement audit and language in the audit report; (2) information on the audit team and engagement statistics; (3) information on the audit process; (4) further information on the results of the auditor's evaluation of the financial statements; and (5) disclosures beyond the scope of the financial statement audit. With regard to the format of the audit report, we distinguish: (1) the existing audit report; (2) a one-sentence "pass/fail" audit report; (3) a one-sentence audit report containing a score on the fairness or quality of the financial statements; (4) the existing audit report supplemented with additional information in an auditor's discussion and analysis section in a free form; (5) the existing audit report with an expanded use of emphasis of matter(s) paragraphs with references to the company's financial statements in specific areas; and (6) the existing audit report with a statement of audit approach as a justification of the auditor's assessment.

We subsequently presented our framework containing the classification of additional disclosures and potential formats to auditors, investors and other financial statement users. We asked their opinion on how the information value of the audit report could be improved. Based on the interviews that we conducted, we conclude that (1) users want a conclusion on the fairness of the financial statements as is included in the existing audit report but preferably located more in the front of the report; (2) users do not seem to show much interest in how the auditor arrived at his conclusion, the composition of the audit team and engagement statistics; (3) users want to be able to rely on the public oversight body, the reputation of the audit network and the audit committee in safeguarding audit quality; (4) users would like to have more information on a number of auditor findings some of which imply an extension of the scope of the audit; (5) users do not attach much value to boilerplate statements included in the audit report; and (6) users indicate that they may benefit from some additional educational material on the scope of the audit and language used in the audit report.

Supplemented with our own views, these conclusions lead us to propose an audit reporting model structured around the following four main information items:

(1) Scope of the audit: listing of items that are part of the audit (e.g., financial statements, management discussion & analysis, internal control). The items that are part of the audit can be determined by what national legislators prescribe and what audit committees voluntarily demand. To explain what an audit of each of the listed elements that are part of the audit entail, reference can be made to educational material which is made available on a website or from another publicly available source.
(2) Findings of the audit: the auditor's conclusion on each of the items that are part of the audit. These conclusions should be unequivocal.

(3) Auditor discussion and analysis: a discussion and analysis of the auditor's findings on each of the items that are part of the audit. This discussion should be intended to facilitate an understanding of the auditor's conclusion on each of the items that are part of the audit and should not qualify the auditor's conclusion as this would transfer the responsibilities of the auditor to the user.

(4) Information on the auditor: reference could be made to the audit firm's transparency report and the report of the public oversight body to allow users to form an opinion on the quality of the auditor.

Our literature review and interviews also lead us to propose a number of suggestions for future research on auditor reporting. In our opinion future research seems warranted before regulatory action, if any, is undertaken, especially to advance our knowledge on the *effects* of changes to the audit report proposed by different parties. We have classified our suggestions for future research into five categories:

(1) Perceived usefulness, change in decision-making behavior and impact on audit quality of alternative reporting formats;
(2) Unintended consequences of changes to the audit reporting model;
(3) Cost/benefit analysis;
(4) Development of educational material;
(5) Division of responsibilities.

Our proposed auditor reporting model may be a first step in closing the information gap, which is currently the focus of regulators and standard setters. However, in order to take audit reporting to a next level, we suggest that this should go hand in hand with a change in the corporate reporting model (such as integrated reporting), of which financial reporting is one, albeit major, component. This will most likely imply an extension of the scope of the audit and possibly also a change in the frequency of reporting. Auditors are also fully aware of this: the auditing profession exists to serve the public interest and if society demands a different corporate reporting model, then auditors have to respond and facilitate this demand to enhance the value of the audit. At the same time, it should be clear that the auditor cannot be considered as the 'holy grail' to meet all information demands of users. Auditors are only one of the many different players in the governance of business reporting, besides standard setters, public oversight bodies and audit committees. We must not forget that management is ultimately responsible to provide stakeholders with the information they need. This responsibility cannot be transferred to standard setters, regulators, public oversight bodies, auditors or any other governance mechanism.

Chapter 1: Introduction

Audit reporting has a long history. The audit reporting format has been subject to change over time and across jurisdictions. For a historical overview, we refer to IOSCO (2009) and PCAOB (2011b). Academic research has also examined the issue of audit reporting for decades. For an overview of academic research on audit reporting, we refer to Church et al. (2008). Regulators and standard setters usually propose a change in regulation following a particular event. Recently, the financial crisis was the trigger for regulators and standard setters to revisit the audit report (e.g., IOSCO 2009, EC 2010, IAASB 2011a, PCAOB 2011b). While narrowing the audit expectation gap has been the main objective of previous changes to the audit report (e.g revised ISA 700), currently the focus is placed on narrowing the information gap. As explained in the IAASB consultation paper (2011a), the expectation gap relates to the "difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is", while the information gap relates to "the existence of a gap between the information they [users] believe is needed to make informed investment and fiduciary decisions, and what is available to them through the entity's audited financial statements or other publicly available information".

While there is broad support that the external audit, in its present form and scope, is valuable, it is also considered that the value of auditor reporting may be enhanced (e.g., MARC 2010a, Gray et al. 2011, IAASB 2011a, PCAOB 2011b). In its Green Paper on Audit Policy (2010) the EC states that "it is important to clearly define what sort of information should be provided to stakeholders by the auditor as part of its opinion and findings; this would not only imply revisiting the audit report but also considering additional communication on audit methodology explaining to what extent there has been substantive verification of the audited company's balance sheet". Auditors are considered to be in a unique position to have significant information on the (audit of the) company's financial statements which may be valuable to share with investors and other financial statement users (PCAOB 2011b). The central question in the current debate on audit reporting boils down to whether the standard audit report communicates the appropriate information to stakeholders and whether its form and content promote audit quality (IOSCO 2009). There are a number of criticisms on the standard audit report which IOSCO (2009) summarizes to fall into three categories: (1) expressing an opinion that is binary in nature may not be optimal for today's complex business environment; (2) the standard audit report contains boilerplate and technical language; and (3) the standard audit report does not reflect the level of effort and judgment inherent in an audit.

To contribute to the current debate, MARC has been commissioned by ACCA to perform a study on extended audit reporting. In particular, MARC has been asked to: (1) develop a framework for extended audit reporting based on a review of the literature on possible additional disclosures in the audit report and possible audit reporting formats; and (2) validate this framework based on discussions with a limited number of stakeholders (users and auditors) to develop an agenda for future research.

The remainder of this report is organized as follows. Chapter 2 presents a literature review which we use as a basis to develop an extended audit reporting framework. Chapter 3 presents the main findings from our interviews with users and auditors on the proposed extended audit reporting framework and concludes with a proposed audit reporting model. Chapter 4 proposes a research agenda. Chapter 5 summarizes our conclusions.

Chapter 2: Literature review and framework for extended audit reporting

2.1 Introduction

In this chapter we review the literature that we use as a basis to develop an extended audit reporting framework. We begin by showing that although prior literature provides evidence that audit reports have information value for users and have an impact on user decisions, there are indications that changes to the audit report could increase its information value. Furthermore, there is still an audit expectation gap, and even an information gap, that might be addressed by extended audit reporting. The core of our literature review discusses the studies on which we base our framework for extended audit reporting. In doing so, we distinguish between the contents of the audit report on the one hand, and the format of the audit report on the other. We end our literature review with a summary in tabular form of the developed framework for extended audit reporting.

2.2 Information value of audit reports

Over the past 40 years research in auditing has attempted to measure the benefits of external auditing, and an important subset of that research has examined the information value of audit reports.

Market reactions

Especially in a UK and US context, but also in other settings, studies have investigated the market reaction to the issuance of certain specific types of audit opinions. These are studies that Holt and Moizer (1990) classify as reaction studies. Some of these studies find evidence of a market reaction. For example, for a sample of US listed firms, Loudder et al. (1992) find that issuance of a “subject to” audit opinion on or after the earnings date results in negative cumulative abnormal returns. Similarly, for a sample of listed US bankrupt firms, Chen and Church (1996) find that firms receiving going concern opinions experience significantly lower negative excess returns than firms receiving an unqualified opinion, suggesting that these opinions have information value for investors. Furthermore, for a large sample of French listed companies that have received qualified audit opinions Soltani (2000) finds that these companies experience significantly negative abnormal returns around the announcement date of the qualified audit opinion. Finally, for a sample of Greek IPOs, Ghicas et al. (2008) find that auditor issuance of certain types of qualified opinions provide valuable information to investors as these downwardly adjust stock prices based on this information.

Other studies, however, do not find evidence of a market reaction. For example, for a sample of listed US companies, Mittelstaedt et al. (1992) find that issuance of a consistency-modified opinion (i.e., an audit opinion modified for inconsistent application of generally accepted accounting principles by the auditee) does not result in a discernible market reaction. Similarly, for a sample of Spanish listed firms, Pucheta Martínez et al. (2004) show that abnormal returns do not differ significantly between firms receiving qualified opinions and firms receiving unqualified opinions, suggesting that qualified audit reports do not provide (differential) information content to investors. However, although Herbohn et al. (2007) find no short-term market reaction for first-time receivers of going-concern opinions for a sample of Australian listed firms, they do, however, find significantly negative market reactions in the 12 months prior to the issuance of a going concern opinion, suggesting the auditor only confirms what investors already now.

Loan officers' perceptions and decisions
A number of other studies have examined the impact of audit opinion types on loan officers' perceptions and decisions. Overall, the results seem to suggest that audit quality and auditor independence are relevant for their decisions, and that information contained in audit opinions matters to them. In a very early study, and based on an experiment, Firth (1980) finds that UK bank loan officers grant significantly smaller loans to companies receiving going-concern audit qualifications and asset valuation audit qualifications. Also based on an experiment, with US bank loan officers, Bamber and Stratton (1997) report that compared to clients receiving a clean audit opinion, clients receiving a modified audit report are less likely to be granted a loan, are charged a higher interest rate, and are assessed to be riskier. Similarly, based on a survey, Dúrendez Gómez-Guillamón (2003) finds that Spanish credit institutions consider the audit report to be essential for loan decisions, and audited financial statements and the audit report to be among the most relevant sources of information used for making these loan decisions. Furthermore, the type of audit opinion also affects their lending decisions, and even the lending amount. Guiral-Contreras et al. (2007) present results in line with those above. Based on an experiment among loan officers from Spanish financial institutions, they show that the officers' assessment of the riskiness of the loan request is significantly affected by the type of audit report issued by the auditor. Specifically, clients with a qualified audit report are considered more risky than clients with an unqualified report, particularly when the qualified report is in contrast with the financial results as presented in the client's financial statements. This result suggests that loan officers consider the (qualified) audit report as a useful and independent piece of information in their loan rating decisions. Finally, Schneider and Church (2008) examine the effect of internal control audits on loan officers' assessment of firm creditworthiness. They find that loan officers assign a higher level of risk, and a lower probability of granting a loan, to a firm receiving an adverse internal control opinion compared to a firm receiving an unqualified internal control opinion. This result suggests that internal control audits have information value for the users of this information.

Only one study finds that the type of audit report does not affect lenders' decisions. Based on an experiment with Australian bank loan officers, Bessel et al. (2003) conclude that modified audit reports have no influence on their loan-related decisions or perceptions, as the type of audit report has no significant effect on either loan approval or amount to be loaned.

Venture capitalists
Two studies focus specifically on the value of audited information and audit reports for venture capitalists. Although the amount of evidence is limited, it seems that venture capitalists have no particular preference for audited information, and audit reports, in making their investment decisions. Wright and Robbie (1996) survey UK venture capitalists on the information sources and techniques that they use in their pre-investment decision-making, that is, in making the "buy" (or invest) decision. Besides their own due diligence report, venture capitalists rate accounting statements as one of their most important sources of information. However, unaudited information is considered equally important, and qualified audit reports are perceived no more important than a number of nonfinancial sources of information.

Manigart et al. (1997) extend Wright and Robbie (1996) with a survey of UK, French, Belgian and Dutch venture capitalists. With a few exceptions, their results confirm those of Wright and Robbie

(1996). Financial statements are considered almost as important as a source of information as the venture capitalists' own due diligence report, but unaudited information is appreciated as well. Audit reports are also used, and qualified reports more so than unqualified reports, but other sources of (nonfinancial) information are considered just as, or even more, important.

Financial and investment analysts' perceptions and decisions

A fair number of studies have investigated analysts' use of information in audit opinions, as well as their perception of messages communicated by audit opinions and the related information content. Spanish financial analysts surveyed by Dúrendez Gómez-Guillamón (2003) indicate that the type of audit opinion affects both investment analysts' investment decision and the amount to be invested.[1] However, results from a survey among Dutch investment analysts by Vergoossen (1993) indicate that although audit reports contain useful information, other sources of information are consulted in their investment decision as well. This finding is confirmed by Bartlett and Chandler (1999) for a sample of UK private shareholders.

Firth (1980) finds that analysts' credit ratings are impaired for companies receiving going-concern audit qualifications and asset valuation audit qualifications, suggesting that such qualifications have information value for analysts.[2] In line with these findings, and based on an experiment among US financial analysts, O'Reilly et al. (2006) conclude that receipt of a going-concern audit report has a negative effect on analysts' stock price estimates. They also find that this negative effect is reduced when analysts perceive that any associated losses can be recovered from the auditor. However, for a sample of Greek initial public offerings Ghicas et al. (2008) find that certain types of qualified audit opinions do not affect analysts' earnings forecasts.[3] This suggests that audit opinions do not have information value for analysts in this case.

In another early study, based on an experiment among North American certified financial analysts, Bailey (1981) shows that according to analysts, the audit report conveys more about the auditor's credibility than about management's credibility. A substantial number of analysts also consider the auditor to be the sole source of financial statement information, rather than management, who is responsible for this information. Furthermore, for analysts the auditor's credibility is dependent on the type of audit report issued, with auditors issuing adverse opinions having the highest credibility and auditors issuing unqualified opinions having the lowest credibility. These results suggest the existence of an audit expectation gap (see section 2.3 for a further discussion of the audit expectation gap). Bailey's results are in line with Robertson (1988). Based on an experiment among US financial analysts, he finds that analysts have trouble in properly interpreting different types of audit reports. Regulators shared this concern since the US Auditing Standards Board changed the audit report qualification system shortly after this study was conducted. In contrast, however, Gaffney and Lynn (1991) find that US analysts are very well able to distinguish among messages communicated by different audit reports for municipalities. Furthermore, analysts' perceptions were in line with the auditors' perceptions, suggesting that an expectation gap is less of a problem in this particular context.

[1] Note that Dúrendez Gómez-Guillamón (2003) finds similar results for bank loan officers (see above).

[2] Note that Firth (1980) finds comparable results for bank loan officers (see above).

[3] However, they do find that these audit opinions provide valuable information to investors (see above).

Going concern modified audit opinions and business failures

Finally, many studies have examined the ability of going-concern (modified) audit opinions to predict business failures and bankruptcies, predominantly in a US context. For a sample of 134 bankrupt US listed companies McKeown et al. (1991) find that going concern qualifications are issued for less than half of these companies. In a subsequent study and for a similar sample, Hopwood et al. (1994) find that auditors are not worse predictors of bankruptcy than statistical prediction models. However, neither seem to be particularly good predictors. Similar results, also for a US sample of 165 listed bankrupt companies, are found by Kennedy and Shaw (1991). Geiger et al. (2005) examine going concern opinions issued to 226 financially distressed US listed companies for more recent periods, and find that auditors are significantly more likely to issue going-concern opinions after December 2001. According to the authors, this suggests that auditors have become more conservative in the aftermath of the highly profiled business failures and in the transition to the Sarbanes-Oxley Act of 2002. One of the few studies conducted in a non-US context, Gaeremynck and Willekens (2003) find that for a sample of 228 mandatorily audited Belgian private companies subsequent business termination (either through bankruptcy or voluntary liquidation) increases the client company's probability of receiving a non-clean opinion. In turn, the issuance of a non-clean opinion further increases the client's financial difficulties since the likelihood of bankruptcy (but not voluntary liquidation) increases for companies receiving such an audit opinion. Similarly, and also in a Belgian setting, Vanstraelen (2003) finds that going-concern opinions significantly increase the probability of bankruptcy.

Conclusion

Based on the above it is fair to state that although the audit report affects users' perceptions and decisions, and therefore has information value, evidence from prior research also suggests that there is room to increase the information value. This also follows from studies that have examined the audit expectation gap, which we discuss below.

2.3 Audit expectation gap and auditor reporting

Results reported by Bailey (1981), discussed in section 2.2, indicate that financial statements and audit report users have a different understanding of the auditor's responsibilities than auditors. This suggests the existence of an audit expectation gap, defined by Monroe and Woodliff (1993) as a difference in perception between auditors and financial statement users, and society at large, of the auditors' duties and responsibilities and messages conveyed by the audit report. For example, Humphrey et al. (1993) survey a large group of UK accountants, finance directors, investment analysts, bankers and financial journalists on the role and nature of auditing and auditor performance attributes, and they find significant differences of opinion between the respondent groups. Evidence of the existence of an audit expectation gap has been provided for many other settings, such as China (Lin and Chen 2004), Hong Kong (Leung and Chau 2001), Finland (Troberg and Viitanen 1999), New Zealand (Porter 1993; Porter and Gowthorpe 2004), Singapore (DeMartinis and Kim 2002), South Africa (Gloeck and Jager 1993), Spain (García-Benau et al. 1993) and the US (Epstein and Geiger 1994).

Of particular interest to the current study are studies that examine the audit expectation gap in relation to auditor reporting. Holt and Moizer (1990) classify these studies as interpretation studies.

In an Australian setting Monroe and Woodliff (1994) survey both auditors and users and find that although modified wording of the audit report helps to eliminate some of the differences in perception between auditors and users, it also introduces new differences. Also in an Australian context, Gay et al. (1998) survey auditors and users, and find that users have a hard time distinguishing between the messages conveyed by a (negative assurance) review report and a (positive assurance) audit report. Furthermore, users assign more responsibility to the auditor than is justified. In another Australian study, Schelluch and Gay (2006) again survey both auditors and users, and find substantial differences between auditors and users on audit report messages on prospective financial information. Furthermore, auditors and users had a very different perception as to the auditors' responsibilities regarding prospective financial information.

In the UK, Innes et al. (1997) survey users and auditors and find significant differences in perception of the audit and the auditor's role and responsibilities based on information provided by the auditor in a short form audit report. Results show that the number of differences decreases somewhat based on an expansion of the audit report (in the context of UK SAS 600 on audit reports), but important differences remain. Similarly, Manson and Zaman (2001) survey UK auditors, preparers and users to examine whether changes to and extensions of the audit report (again in the context of UK SAS 600) have succeeded in decreasing differences of opinion between the three groups. Results of the study show that this is indeed the case, but also that users require additional information in the audit report to meet their expectations and to increase the information value of the audit report.

In a US context, Ponemon and Raghunandan (1994) confirm Australian and UK evidence in that there are significant perceptual differences between auditors and users as to the message conveyed by audit reports. In particular, based on a survey users perceive audit reports to provide more assurance about a client's ability to continue as a going concern than auditors do. Almer and Brody (2002) confirm this result in a similar study. Furthermore, McEnroe and Martens (2001) survey US auditors and investors and find that although both parties agree on the meaning and terminology used in the audit opinion, there is less agreement as to what the auditor's related responsibilities are. In general, investors assign much more and also more far-reaching responsibilities to the auditor than the auditor is willing (and required by regulation) to assume, again suggesting an expectation gap.

Recently, Arnold et al. (2011) show that professional (albeit to a lesser extent) and nonprofessional investors believe that nonfinancial information such as MD&A in the US 10-K report is audited when it is not. The results further suggest an unmet demand for greater assurance of nonfinancial information for both investor groups.

In light of the above, many efforts have been made in the past to reduce the expectation gap by attempting to improve auditor communication with users and stakeholders through changes to the audit report (see e.g. IOSCO 2009; IAASB 2011a). However, given the recent renewed attention for the value of auditor reporting, as evidenced by research reports, discussion reports, consultation papers, and roundtable discussions by, for example, IOSCO (2009), EC (2010), ACCA (2010a, 2010b), ICAEW (2010), ICAS (2010), FRC (2010), IAASB (2011a, 2011b), and PCAOB (2011a, 2011b), this matter is far from settled.[4] To inform this debate, the current study proposes a framework for extended audit reporting based on an examination of prior academic and professional literature, and distinguishes between extensions to the contents of the audit report on the one hand, and to the format of the audit report on the other. We discuss this literature below.

2.4 Extended audit reporting: Contents of the audit report

Based on our review of the academic and professional literature, we distinguish five categories of information that could be included in an extended audit report. We discuss each of the categories, and the disclosure items per category, below.

I. Clarification of the scope of the financial statement audit and language in the audit report

Information in this category focuses on the role of the auditor, the scope of the financial statement audit and the language used in the audit report. Prior research on the audit expectation gap, discussed above, has shown that financial statements and audit report users, and actually society at large, generally do not understand the audit function or the auditor's duties and responsibilities (Porter et al. 2009). This suggests that providing more extensive information on these issues might help users understand the role of the auditor, the purpose of a financial statement audit, as well as the limitations of such an audit. We identified a number of disclosure items that can help to achieve this goal:

- A clarification of the objective of the financial statement audit (see e.g. McEnroe and Martens 2001; Chong and Pflugrath 2008; Church et al. 2008)[5].
- The level of assurance offered by the financial statement audit, the audit risk borne by the auditor and the materiality level set for the financial statement audit. Research has shown that more often than not, users assume that auditors provide absolute, rather than reasonable assurance that the financial statements are free of material misstatements (see e.g. Gold et al. 2010). Relatedly, users have difficulty understanding the concept of audit risk and materiality (see e.g. Gray et al. 2011).
- The auditor's responsibility with regard to fraud. There is not only prior evidence that users expect the financial statements to be absolutely free of material misstatements due to errors, but also due to fraud (see McEnroe and Martens 2001; Porter et al. 2009; IAASB 2011a).
- The auditor's responsibility in auditing disclosures beyond the traditional disclosures in the financial statements. In its discussion paper on the changing nature of financial reporting, the IAASB (2011b) asks what the audit implications of these financial reporting developments might be. Given the novel nature of these changes, and the expected increasing importance of these financial reporting disclosures, a clarification of the auditor's responsibilities might help users understand the auditor's role in this regard.[6]

[4] IOSCO (2009) also discusses the presence of an "information gap", asking whether investors are receiving sufficient adequate information to make investment decisions. See also IAASB (2011a).

[5] Note that we include more references for each disclosure item in our framework in Table 1. However, please note that our list of references is representative rather than exhaustive.

[6] The IAASB (2011b) distinguishes the following categories of disclosures: (1) significant accounting policies; (2) components of line items; (3) factual information about the entity; (4) judgments and reasons in applying accounting policies and management decisions; (5) assumptions, models and inputs relevant to the calculation of items in the financial statements ; (6) sources of estimation uncertainty and sensitivity analysis; (7) descriptions of internal processes; (8) fair value disclosures; and (9) overarching objective-based disclosures.

- The auditor's responsibility with regard to the director's report included in the client's financial statements and the auditor's responsibility with regard to the client's operational and financial review. Prior studies have shown that audit report users are interested in information on the extent of the auditor's examination of the director's report and the operational and financial review (McEnroe and Martens 2001; Church et al. 2008).
- Identification of (other) items outside the scope of the financial statement audit. A number of professional and supervisory bodies have discussed whether the auditor's duties may require extension (see e.g. ACCA 2010b; EC 2010), and there is evidence that users appreciate information on issues that currently go beyond the scope of the financial statement audit. For example, MARC (2010a) finds that users are interested in the auditor's holistic view of the auditee's business, and ACCA (2010b) indicates users would appreciate information that is more forward-looking, qualitative and/or nonfinancial. This, in turn, may change the role of the audit.[7]

II. Information on the audit team and engagement statistics

This category includes information related to the audit team and the audit engagement. More extensive information in this regard may help audit report users to assess and understand the quality of the audit engagement. Current research mainly relies on the Big Four vs. Non-Big Four distinction to measure audit quality, and generally finds that Big Four firms are perceived to deliver higher quality than Non-Big Four firms (Gray and Ratzinger 2010). To allow audit firms to provide users with information on audit quality characteristics beyond this broad distinction, we distinguish the following potential disclosure items:

- The engagement partner's name and signature. Prior research argues that increased accountability on the part of the audit partners due to disclosure of his name and signature will increase the quality of the audit (see e.g. Gray et al. 2011), and users have indicated that they would like to see this information included in the audit report (Porter et al. 2009; CFA Institute 2011).
- The auditing and industry experience of the engagement partner. Research in auditing is abound with evidence that auditors with more experience and expertise deliver higher quality audits (see e.g. Balsam et al. 2003; Dunn and Mayhew 2004; Gul et al. 2009), and users have indicated that they would appreciate related information in the audit report (CFA Institute 2010).
- The composition of the audit team on the engagement and (the proportion of) time spent on the engagement by each level of audit staff.[8] Prior research has shown that the effect of client characteristics on time spent on the audit differs per audit staff level (O'Keefe et al. 1994; Hackenbrack and Knechel 1997). Since the time spent on the audit directly affects the assurance level provided by, and therefore the quality of, the audit, such information might be helpful to audit report users (CFA Institute 2010).
- The involvement of specialists in the audit engagement, the amount of time they have spent on the audit engagement, and the areas of the financial statement audit for which they have been

[7] In its consultation paper on auditor reporting, the IAASB (2011a) also provides a number of other examples of items that currently are beyond the scope of the financial statement audit: corporate governance arrangements; business model, including its sustainability; enterprise-risk management; internal controls and the financial reporting process; and key performance indicators. Some of these examples are included in our Category IV.

[8] Generally, a distinction between the following staff levels is made: assistants, seniors, managers, and partner or director.

engaged. The auditor may have to consult with outside specialists for certain parts of the audit, such as engineers, real estate appraisers, and actuaries (Knechel et al. 2007). The quality of these specialists has a direct bearing on the quality of the audit, and therefore users may benefit from related information in the audit report (Johnstone and Bedard 2001, 2003; Schelleman and Knechel 2010).

- The importance of the client to the audit firm and the audit office in terms of revenues obtained from the client compared to the total revenues of the firm and office. Since auditors are paid by their clients they can never be fully independent from these clients. Furthermore, larger clients represent a larger relative stake in the audit firm's (and particular audit office's) revenues, and may therefore present a larger threat to the auditor's independence and audit quality (Reynolds and Francis 2001). Users may thus be interested in seeing such information included in the audit report (CFA Institute 2010).
- Other issues related to auditor independence, including a discussion of threats and safeguards. Examples of such issues include the provision of nonaudit services (e.g. Frankel et al. 2002), the length of audit firm and audit partner tenure (Carcello and Nagy 2004; Carey and Simnett 2006), and the effect of audit firm and audit partner rotation (Carey and Simnett 2006). Research shows that users value such related information in the audit report (e.g., Hatherly et al. 1991; CFA Institute 2010).

III. Information on the audit process

Information in this category relates to the process of auditing the financial statements. Users may benefit from more extensive information on these issues to help them appreciate the work done by the auditor to evaluate the reliability of the financial statements and related matters, and relate the input by the auditor to the output of the audit, i.e., the auditor's findings (see category IV below). Issues discussed in this category are the audit risk model, including its components risk of material misstatement (inherent and control risk) and detection risk. We distinguish the following specific disclosure items:

- A general risk assessment of the client company. As part of his audit approach, the auditor obtains an overall understanding of the client, including the client's most important risk areas (Knechel et al. 2007). Such information might be useful to financial statements and audit report users to learn the auditor's focus during the audit. Research suggests users might indeed appreciate this type of information (Church et al. 2008; Porter et al. 2009).
- The assessment and sources of the risk of material misstatement. The risk of material misstatement is one of the two main components of the audit risk model (e.g. Knechel et al. 2007), and a proper understanding of this risk can assist users' comprehension of the auditor's findings (see category IV). Factors that affect this risk, and that users may therefore be interested in, include the client's accounting practices, policies, and procedures; the client's accounting estimates and judgment; the client's material assumptions; and the client's control risk (see e.g. EC 2010; Turner et al. 2010; IAASB 2011a; ICAS 2010).
- The assessment and sources of detection risk. Detection risk is the other main component of the audit risk model, and like for the risk of material misstatement, knowledge of this risk can help users (better) understand the auditor's findings (category IV). The following information may be of interest to users: the level of materiality that the auditor has applied to the engagement; financial statement components that the auditor has directly verified by means of substantive testing; financial statement components that the auditor has verified on the basis of his

professional judgment, internal models, assumptions, and/or management explanations; the extent to which the auditor has relied on the client's internal controls during the audit (based on the auditor's assessment of the client's control risk, see above); and the use and extent of sampling methods (see e.g. Fisher 1990; EC 2010; Gold et al. 2010; Gray et al. 2011).

- As indicated above under category I, current discussions on the relevance of disclosures beyond traditional financial statement disclosures (see IAASB 2011b) may not only have implications for financial reporting but also for the audit of financial reporting. Therefore, users may be interested in the importance of those disclosures in the current audit engagement and the audit implications of these disclosures for the current engagement (IAASB 2011a; 2011b).

IV. Further information on the results of the auditor's evaluation of the financial statements

This category concerns information on the results of the auditor's evaluation of the financial statements. Ultimately, users will be interested in learning what the auditor's conclusions are based on, the procedures that he has performed and the evidence that he has collected during the audit. Results that the user would like to see reported may include those that are currently already disclosed in the audit report (such as the auditor's opinion on the true and fair view of the client's financial statements), but also results that are currently only disclosed to management or those charged with governance, or not at all (e.g, sustainability of the client's business; percentage of waived and adjusted misstatements). We distinguish the following specific disclosure items:

- The quality of the client's financial statements. Currently an opinion on the true and fair view of the financial statements is the core of the audit report. Research has shown that users appreciate the auditor's opinion on the reliability and quality of the client's financial statements (see e.g. Church et al. 2008; Porter et al. 2009; CFA Institute 2010; Gray et al. 2011).
- The quality of the client's internal control system. Although the audit risk model requires the auditor to assess the quality of the client's internal control system in the process of the financial statement audit, currently the results of such assessments need to be disclosed in the audit report in only a few jurisdictions. The most prominent example is of course the US, where the Sarbanes-Oxley Act requires auditors to report their assessment of the quality of the client's internal control system since November 2004 (Raghunandan and Rama 2006). Prior research indicates users appreciate information on the quality of the client's internal control systems (see e.g. Manson and Zaman 2001; CFA Institute 2010; Gray et al. 2011).
- The likelihood of fraud and illegal acts. Although the auditor is responsible to plan his audit in such a way that he can provide reasonable assurance that material (errors and) fraudulent misstatements[9] as well as violations of relevant laws with a direct and material effect on the financial statements are detected[10], there is currently no requirement to report on such matters in the audit report. However, there is research to show that users would like to see related information in the audit report (e.g., McEnroe and Martens 2001; Church et al. 2008; CFA Institute 2010).
- An assessment of potential going concern problems. As part of a financial statement audit, the auditor needs to assess whether the client will be able to continue as a going concern over the

[9] See International Standard on Auditing 240 (The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements).

[10] See International Standard on Auditing 250 (Consideration of Laws and Regulations in an Audit of Financial Statements).

next financial year.[11] If the auditor concludes that there is a material uncertainty in this respect, he needs to disclose this in his audit report, either in an emphasis of matter paragraph in an unmodified opinion, or in a qualified or adverse opinion.[12] Research shows users value this information, and might even desire more extensive information in this regard (e.g. Manson and Zaman 2001; Porter et al. 2009).

- An assessment of the sustainability of the client's business. Turner et al. (2010) argue that based on his audit the auditor has collected relevant information regarding the client's risks and viability, which could prove valuable to financial statement users. In this regard, additional disclosures in the audit report may therefore be useful.
- Information on the auditor's communication with those charged with governance, such as significant difficulties that the auditor has encountered during the audit, any disagreements with management, the extent of interaction between the auditor and those charged with governance, and key issues that the auditor discussed with those charged with governance. During the course of the audit, the auditor communicates with client governance bodies, such as the audit committee. Research suggests that information regarding those communications may be useful to financial statement users (e.g. Church et al. 2008; IOSCO 2009; FRC 2011; IAASB 2011a).
- The percentage of waived and adjusted misstatements in the financial statements. Prior research has examined the extent to which auditor-proposed adjustments were ultimately waived by the auditor as a signal of the strength of the auditor's negotiation power vis-à-vis the client (see e.g. Church et al. 2008). Although currently not disclosed in the audit report, related information may be, as such, useful to financial statement users (McEnroe and Martens 2001; Porter et al. 2009).
- Information disclosed in the management letter. During his audit, the auditor collects evidence that may not be of direct consequence to the client's financial statements, but that may nonetheless be useful for client management to help improve performance. The auditor may communicate this information to management by means of a management letter (Knechel et al. 2007). Prior research suggests that users may also be interested in this information, which could therefore be included in an extended audit report (e.g. ACCA 2011a; Gray et al. 2011).

V. Disclosures beyond the scope of the financial statement audit

The fifth and final category concerns information that goes beyond the scope of the financial statement audit. This relates to issues discussed in the previous category IV insofar as these are not currently part of the financial statement audit (for references see above). Furthermore, under category I above we discussed a number of issues that are currently outside the scope of the financial statement audit but that a number of professional and supervisory bodies suggest as extensions to the auditor's duties. Whereas the related extended disclosures in category I are intended to clarify the auditor's responsibilities in this regard, the additional disclosures for these items in the current category would relate to the auditor's process and the results of his evaluations of these issues. These could include an auditor-provided holistic view of the client's business (MARC 2010a; ACCA 2010b; IAASB 2011a), the auditor's opinion on forward-looking, qualitative and/or nonfinancial client data (Porter et al. 2009; EC 2010; ICAS 2010; Turner et al. 2010), and a number of (other) examples discussed by the IAASB (2011a) in its consultation paper on auditor reporting. These include auditor-

[11] See International Standard on Auditing 570 (Going Concern).

[12] See International Standard on Auditing 570 (Going Concern) and 705 (Modifications to the Opinion in the Independent Auditor's Report).

initiated disclosures on the client's corporate governance arrangements; the client's business model, including its sustainability; the client's system of enterprise-risk management; the client's internal control system and the financial reporting process; and key client performance indicators.[13]

A number of recent reporting initiatives and developments already provide a glimpse of potential extensions of the scope of the auditor's role and responsibilities. For example, as of June 2010 companies listed on the Johannesburg Stock Exchange (JSE) are required to comply with the King Report on Corporate Governance for South Africa published in 2009 (IoDSA 2009). Following a comply-or-explain principle, JSE-listed companies are required to either publish a so-called integrated report, or explain why they do not. Such an integrated report should combine financial and non-financial information such that it provides "a holistic and integrated presentation of the company's performance in terms of both its finances and its sustainability" (IoDSA 2009). Although currently the auditor is required to only provide assurance on the financial statements in the integrated report, a recent discussion paper by the Integrated Reporting Committee of South Africa (IRC 2011) recommends independent assurance of the other parts of the integrated report as well, and welcomes discussion on these matters. We note that currently a number of professional bodies and standard setters such as the FEE and IAASB have task forces in place working on the issue of integrated reporting.

An example of what an "integrated audit report" could look like is provided by the Port Authority of Rotterdam, which has been issuing integrated annual reports on a voluntary basis since 2009. In its integrated annual report the Port Authority combines the report of the executive board, the financial statements, the corporate social responsibility report and other information into one single report. Its auditors not only audited the financial statements in the report, but the report of the executive board as well (with the exception of information about future developments). The quality of other parts of the annual report were assessed and assured by other (both internal and external) parties. The annual report including the audit report is available on the website of Port Authority of Rotterdam (http://www.portofrotterdam.com/en/Port-authority/finance/annual-report/Pages/default.aspx).

2.5 Extended audit reporting: Format of the audit report

Based on our review of academic and professional literature we distinguish a number of possible audit reporting formats below.

A first option is, of course, to maintain a status quo and keep the current, existing audit report, as many prior studies discussed in section 2.2 indicate that this report does, indeed, have information value for users.

A second option would be a one-sentence "pass/fail" audit report. This is in line with McEnroe and Martens (2001) who find that for the majority of report users the fact that an audit opinion is unqualified or not is more important than specific terminology used in the report.

A similar possibility is a one-sentence audit report containing a score (for example between 0 and 10) on the fairness or quality of the financial statements. Similar in nature to practices used by credit

[13] Note that some of these examples are included in category IV above.

rating agencies (EC 2010), this could add granularity to the audit report (Gray et al. 2011) and as such be informative to report users.

As discussed in section 2.4, there are several suggestions to extend the format of the audit report. These additions could be presented in a free form. According to Hatherly et al. (1998), additional disclosures in the audit report in a free form, similar to internal reporting between the auditor and those charged with governance, are perceived to increase the value and credibility of the audit. Such supplemental information could include areas of audit judgment, waived and adjusted misstatements, and recommendations to management as a result of the audit. Discussing these issues in a free form could help avoid use of boilerplate language (Church et al. 2008), and would be tailored to each audit (Turner et al. 2010). Such a free-form audit report resembles a German long-form audit report, prepared for internal use submitted to the client's supervisory board by the auditor.

A further option is to supplement the existing audit report with expanded emphasis of matter(s) paragraphs (see e.g., Hatherly et al. 1991; IAASB 2011a). Such paragraphs would then refer to certain areas in the client's financial statements that, according to the auditor, require specific discussion for the benefit of the report users. Although currently already employed by the auditor,[14] for example to draw report users' attention to potential going concern problems on the part of the auditee, its current use could be expanded to increase the information value of the audit report to users.

A final option is to supplement the existing audit report with a statement of audit approach as a justification of the auditor's assessment, in line with the current French and Japanese audit report format. French law requires the auditor to justify his opinion to audit report users in the statement of audit approach section of the audit report, where he needs to discuss his assessment of significant accounting estimates or judgments in forming his opinion and the key audit procedures that he has performed with regard to these estimates and judgments (see e.g. IOSCO 2009; Turner et al. 2010; IAASB 2011a).[15] In Japan, the audit report also contains a more detailed description of the audit and an 'Additional Matters' paragraph describing the judgments made in forming an opinion or other matters that the auditor chooses to emphasize. We note, however, that a survey by the French professional body of auditors (Compagnie Nationale des Commissaires aux Comptes) shows considerable variation in the perceived usefulness of the statement of audit approach across respondents (CNNC 2011).

[14] International Standard on Auditing 706 (Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report), provides the auditor with means to communicate to financial statement users "when the auditor considers it necessary to:

(a) Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or
(b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report."

[15] An example of a French audit report is included in Appendix D of ICAEW (2007).

2.6 Conclusion: Framework for extended audit reporting

We started our literature review by showing that although audit reports have information value for users, there also appear to be opportunities to increase the reports' information value. This might also help to address the audit expectation, or even information, gap. We then presented the literature on which we have based our framework for extended audit reporting, distinguishing between the contents of the audit report and the format of the audit report. The resulting framework is presented in Table 1 below.

Table 1: A Framework for Extended Audit Reporting

Panel A: Contents of the audit report

Category I: Clarification of the scope of the financial statement audit and language in the audit report	
This category focuses on the role of the auditor and the scope of the financial statement audit and includes:	
• Clarification of the objective of the financial statement audit	ACCA (2010a), Chong and Pflugrath (2008), Church et al. (2008), FRC (2011), Gold et al. (2010), Hatherly et al. (1991), Manson and Zama (2001), McEnroe and Martens (2001), PCAOB (2011)
• Level of assurance, audit risk and materiality	CFA Institute (2010), Church et al. (2008), Fisher (1990), Gold et al. (2010), Gray et al. (2011), Hatherly et al. (1991), Manson and Zama (2001), Porter et al. (2009), Turner et al. (2010)
• Auditor's responsibility with regard to fraud	CFA Institute (2010), Church et al. (2008), IAASB (2011a), Gray et al. (2011), Manson and Zaman (2001), McEnroe and Martens (2001), Porter et al. (2009)
• Auditor's responsibility in auditing disclosures beyond the traditional disclosures in the financial statements	IAASB (2011a, 2011b)
• Auditor's responsibility with regard to the director's report	Church et al. (2008), IAASB (2011a), Manson and Zama (2001), PCAOB (2011)
• Auditor's responsibility with regard to the operational and financial review	Church et al. (2008), IAASB (2011a), Manson and Zama (2001), PCAOB (2011)
• Identification of items outside the scope of the financial statement audit	ACCA (2010b), EC (2010), IAASB (2011a), ICAS (2010), MARC (2010a)

Category II: Information on the audit team and engagement statistics	
This category covers information related to the audit team and the audit engagement, including:	
• Engagement partner's name and signature	CFA Institute (2010), Church et al. (2008), Gray et al. (2011), Porter et al. (2009)
• Auditing experience of the engagement partner	Carey and Simnett (2006), CFA Institute (2010)
• Industry experience of the engagement partner	Balsam et al. (2003), Dunn and Mayhew (2004), Gul et al. (2009), CFA Institute (2010)
• Audit team composition and time spent on the engagement by each staff level	CFA Institute (2010), Hackenbrack and Knechel (1997), O'Keefe et al. (1994)
• Involvement of specialists in the audit engagement	Johnstone and Bedard (2001, 2003), Knechel et al. (2007), Schelleman and Knechel (2010)
• Importance of client to audit firm and audit office (revenues)	CFA Institute (2010), Reynolds and Francis (2001)
• Other auditor independence issues	Carcello and Nagy (2004), Carey and Simnett (2006), CFA Institute (2010), Frankel et al. (2002), Hatherly et al. (1991), IAASB (2011a), PCAOB (2011), Porter et al. (2009), Turner et al. (2010)

Category III: Information on the audit process	
Information in this category relates to the audit process, including a discussion of the audit risk model and its components risk of material misstatement and detection risk:	
• General risk assessment of the client	CFA Institute (2010), Church et al. (2008), Knechel et al. (2007), Manson and Zama (2001), PCAOB (2011), Porter et al. (2009)
• Assessment and sources of risk of material misstatement: accounting practices, policies, procedures; accounting estimates and judgment; material assumptions; and internal controls	CFA Institute (2010), EC (2010), IAASB (2011a), ICAS (2010), Knechel et al. (2007), PCAOB (2011), Turner et al. (2010)

(continued on next page)

Table 1 – *continued*	
Panel A – continued	
Category III – *continued*	
• Assessment and sources of detection risk: applied engagement materiality level; financial statement components verified by substantive testing; financial statement components verified based on professional judgment, internal models, assumptions, and/or management explanations; extent of reliance on internal controls; sampling	Church et al. (2008), EC (2010), Fisher (1990), Gold et al. (2010), Gray et al. (2011), IAASB (2011a), Knechel et al. (2007), Manson and Zama (2001), Turner et al. (2010)
• Audit implications of disclosures beyond traditional financial statement disclosures	IAASB (2011a, 2011b)
Category IV: Further information on the results of the auditor's evaluation of the financial statements	
This category relates to results of the auditor's evaluations, including:	
• Quality of the financial statements	CFA Institute (2010), Church et al. (2008), Gray et al. (2011), Manson and Zaman (2001), McEnroe and Martens (2001), Porter et al. (2009)
• Quality of the internal control system	CFA Institute (2010), Church et al. (2008), Gray et al. (2011), IAASB (2011a), Manson and Zaman (2001), Porter et al. (2009), Raghunandan and Rama (2006)
• Likelihood of fraud and illegal acts	CFA Institute (2010), Church et al. (2008), Gray et al. (2011), Manson and Zama (2001), McEnroe and Martens (2001), Porter et al. (2009)
• Going concern assessment	Church et al. (2008), Manson and Zama (2001), PCAOB (2011), Porter et al. (2009), Turner et al. (2010)
• Assessment of sustainability of the client's business	Turner et al. (2010)
• Information on communication with those charged with governance: – Significant difficulties during audit – Disagreements with management – Extent of interaction with those charged with governance – Key issues discussed with those charged with governance	CFA Institute (2010), Church et al. (2008), EC (2010), FRC (2011), IAASB (2011a), ICAEW (2007), IOSCO (2009), Turner et al. (2010), PCAOB (2011)
• Percentage of waived and adjusted misstatements	Church et al. (2008), McEnroe and Martens (2001), Porter et al. (2009)
• Information disclosed in management letter	ACCA (2010a), Gray et al. (2011), IOSCO (2009), Knechel et al. (2007)
Category V: Disclosures beyond the scope of the financial statement audit	
This category relates to information that goes beyond the scope of the financial statement audit, such as:	
• Issues from category IV beyond the scope of the financial statement audit	See references above under Category IV
• Holistic view of the client's business	ACCA (2010b), IAASB (2011a), MARC (2010a)
• Forward-looking information, qualitative and non-financial data	ACCA (2010b), EC (2010), IAASB (2011a), ICAS (2010), Porter et al. (2009), Turner et al. (2010)
Panel B: Format of the audit report	
• The existing audit report	Church et al. (2008)
• A one-sentence "pass/fail" audit report	Church et al. (2008), McEnroe and Martens (2001)
• A one-sentence audit report containing a score (for example between 0 and 10) on the fairness or quality of the financial statements	EC (2010), Gray et al. (2011)
• The existing audit report supplemented with additional information in an auditor's discussion and analysis section in a free form	Church et al. (2008), Hatherlyet al. (1998), Turner et al. (2010)

(continued on next page)

Table 1 - *continued*

Panel B - continued

• The existing audit report with an expanded use of emphasis of matter(s) paragraphs with references to the company's financial statements in specific areas.	Gray et al. (2011), Hatherly et al. (1991), IAASB (2011a)
• The existing audit report with a statement of audit approach as a justification of the auditor's assessment (e.g., discussing the critical judgments made in forming the auditor's opinion and the key audit procedures performed by the auditor with regard to these judgments and reference to the related disclosures in the financial statements).	CNNC (2011), IAASB (2011a), ICAEW (2007), Turner et al. (2010)

Note: the first column in this table corresponds to items discussed in the preceding text on either possible extensions to the contents of the audit report, or changes to the format of the audit report. The second column contains a selection of references that substantiate these. Full details on these references are provided at the end of this report in our reference list.

Chapter 3: Summary of interview findings and proposed audit reporting model

3.1 Introduction

To validate the framework presented in section 2.6, we have conducted interviews with a limited number of preparers and users of the audit report. In particular, we presented our framework containing the classification of additional disclosures and potential formats to auditors, investors and other financial statement users, and asked their opinion on how the information value of the audit report could be improved. Our group of preparers consists of 10 auditors from a number of different audit firms (both Big 4 and second-tier) in several EU countries. Our group of users consists of 10 respondents with a variety of functions such as financial analyst, credit analyst, managing director corporate banking, and investment banker, also from a number of EU countries. In this chapter, we present the main insights that we learned from these interviews.[16]

3.2 Findings from auditor interviews

Auditors are well aware of the fact that they should respond to the demand of audit report users because they serve society and society is the reason for their existence. Accordingly, auditors expect that a change in the business reporting model will occur in the future because of a change in the information demand of users and that this will result in a change in the scope of the audit. Moreover, increased transparency is a trend among investors and it seems that auditors cannot lag behind.

On a scale from 1 to 10 (10 being the highest), auditors' assessment of the information value of the audit report in its present form for investors and other stakeholders ranges from 3 to 9, with an average of 6.3. Interviewees who gave a low score motivated it by referring to the prevailing expectation and information gap between users and auditors. Interviewees who gave a high score indicated that the audit opinion as part of the audit report is of great importance for decision making, even though it could easily be replaced by an 'o.k.'-seal from the auditor without the boilerplate statements inherent in the current binary audit report.

Auditors indicate that they are willing to provide additional information in the audit report, such as information on the scope of the audit and the audit process with the aim to lower the expectation and information gap. The scope of an audit, the auditor's responsibilities with regard to for example fraud, as well as items that are not included in the scope of the audit could, for example, be explained on an independent website. A link to this website could appear in all audit reports with the aim to educate users of the financial statements. Sceptics, however, doubt that this would reduce the expectation gap on a large scale because some users will never be aware of the precise responsibilities of an auditor even if additional descriptions were offered.

Auditors are also willing to disclose information on the results of the auditor's evaluation of the financial statements but only if it is required by law and does not undermine the confidentiality of the auditor-client relationship. Even though auditors agree that certain additional disclosures in the audit report can be useful to investors and potentially reduce the information gap, they also have concerns about extensions to the audit report. For example, additional information in the audit

[16] We conducted our interviews via telephone, based on semi-structured questionnaires specially developed for this purpose. These questionnaires are included in Appendices A and B.

report could create a self-fulfilling prophecy: by disclosing more information on certain risks that the client is exposed to, the client might encounter problems in generating external funds in the future. Moreover, auditors fear that disclosing additional information might lead to an increase in litigation. Furthermore, auditors indicate that the more information is given to the user, the higher the cost in terms of resources and time. Most notably, almost every interviewee indicated that it will generally be difficult for the average investor to understand and interpret some of the additional information. One example relates to the materiality level: During the audit, not one level of materiality is used but many levels, based on the risk involved of the particular line item. If those levels were communicated to investors, auditors argue that most users would possibly 'not see the wood for the trees'.

All auditors agree that no value is added to the audit report when information on the audit team and engagement statistics and the auditor's independence is included. As the respondents argue, this issue is already supervised by the public oversight bodies. Furthermore, the information would be difficult to interpret and easy to manipulate (e.g. determination of whether an audit team member is a specialist). Finally, auditors argue that it is more important that an engagement team works well than who works for how many hours, which is not considered to be an audit quality indicator.

In the opinion of the interviewed auditors, neither the entire management letter, nor the communication between auditor and audit committee, nor any other engagement specific information should be made public, at least not by the auditor because it might damage the auditor-client-relationship, which is based on trust and ethical guidelines.

Providing additional assurance on the types of disclosures discussed in the IAASB discussion paper on the evolving nature of financial reporting (IAASB 2011b) is, according to auditors, only feasible if an appropriate framework is developed to do so. For example, how should an auditor provide assurance on the MD&A of an entity containing forward looking information? Auditors indicate that they could offer to assure that the forecasts were conducted with reasonable care and realistic assumptions.

The majority of the auditors have no preference regarding the final format of the 'new' audit report. The only format that all auditors strongly object to is to rate the fairness of the financial statements by giving an overall score (e.g., between 0 and 10) because aggregation of information into one number suggests accuracy which is difficult to substantiate and might raise even more questions by users. Furthermore, such a score might result in excessive focus on the score while disregarding the underlying content matter, i.e., the quality of the financial statements.

Even if the format is not of uttermost importance, most auditors agree that whichever format will be chosen, a standardization of language and topics will take place. This will benefit the users in terms of having a benchmark but could also lead to new boilerplate statements.

Some auditors do have a slight preference regarding the format. They would like to start with the conclusion/auditor's opinion, followed by an explanation or justification of that conclusion. A justification of the auditor's assessment could include an assessment of the most significant accounting policy choices, significant estimates and judgments, and valuation issues. Furthermore, some auditors indicate that this paragraph could contain information on specific issues that arose during the audit and specific areas which the auditor focused on or were of high relevance for that specific audit.

Overall, it appears that improving the current audit reporting format is possible but not primarily by making a few changes in the wording or format of the audit report. Instead, a change in the business reporting model is called for (e.g. integrated reporting, real-time reporting), which will then entail a change in the scope of the audit. This scope extension needs to be clearly defined and appropriate frameworks to do so need to be developed but is ultimately something society appears to expect in the future.

3.3 Findings from user interviews

Almost all users perceive the current form and scope of the external audit as value adding. On a scale from 1 to 10, their assessment of the information value of the audit report in its present form ranges from 3 to 8, with an average of 6.2. This score also suggests that there is still a lot of room for improvement of the report's information value. Users argue that auditors possess a unique view on the company and should pass part of that knowledge on to the users of the financial statements, who are ultimately the auditor's client. Most users agree that the current audit report is essentially a binary score and in principle they just check presence of any qualifications and the identity of the auditor, whereby the reputation of the audit firm vouches for audit quality.

In essence, all respondents agree that the information value of the audit report could be improved by clarifying the scope of the financials statement audit, especially the auditor's responsibility with regard to fraud and to non-financial information in the annual report, identification of items outside the scope of the audit, as well as a clarification of the level of assurance. However, users could do without additional information on the audit team and engagement statistics since they appear to derive the quality of the audit from the type of audit firm that issues the audit report and rely on the public oversight body. In general, users associate large audit firms with higher audit quality. Users indicate that it is important that audit quality is high and any evidence in this regard would be helpful. A minority of respondents would like to receive additional insights on the audit process beyond the information received through the annual general meeting. Two of the most important pieces of relevant information in this regard seem to be the level of materiality used during the audit and the specific areas that received special attention from the auditor during the financial statement audit (e.g. on which risks the auditor has focused during his audit).

There is mutual consent among the respondents when it comes to including results of the auditor's evaluation. The majority of users want a conclusion on the fairness of the financial statements as is included in the existing audit report and wish to receive information on the most important findings as well as about main challenges which occurred during the course of the audit. This can range from information about the quality of the client's risk management, the effectiveness of the internal control system, and the quality of issuer's accounting policies and practices, to publishing parts of the internal communication between auditor and those charged with governance. Not all respondents demand the full range, especially not the publication of internal communication since the relationship between auditor and client is based on confidentiality. Few users are in favor of publicly disclosing the entire management letter, or parts of it, since they fear that it might grow thin and eventually miss its initial purpose.

Some users would like to see an extension of the scope of the audit (e.g. include an assessment on the effectiveness of the internal control system and risk management system, assurance on MD&A). Others do not prefer an extension of the scope of the audit mainly because it is argued to most likely be too time consuming and auditors should not take on tasks that actually belong to management. For example, a user indicated that he is most interested in what the CEO has to say about the company's future and strategy, and that is not something the auditor has to discuss. The users' views on extending the scope of the audit in terms of demanding a going concern assessment are also mixed. While some interviewees would like to receive a comprehensive assessment about the sustainability of the business beyond a one-year period, other users prefer to assess the macro-economic environment of the business and solvency/liquidity of the company themselves or do not believe it is reasonable to ask auditors to predict the future.

Having had to deal with the financial crisis just recently, one user mentions that the type and range of disclosures should be tailored to the nature of the client's industry. In fact, he argues that auditors of financial institutions should disclose more extensively, especially on valuation issues of assets and liabilities (e.g. by explaining the fair value hierarchy[17]).

A small number of users in our sample indicated that they have private access to the auditor when considering making a major investment in a company. To be able to privately or in the presence of management discuss the significant risks faced by the company with the auditor is considered to be much more valuable than the audit report.

Users' generally prefer application of the 'substance over form' principle when it comes to the format of a potential new audit report. Even if they express different preferences, the ultimate goal for all users is to have a readable and interpretable audit report, without an overload of information. Some users indicate that their time to read reports is limited and would like to see the conclusions more in the front of the report. Some prefer the existing audit report with either supplemental information in a free-form auditor's discussion and analysis section without boilerplate language, or an expanded use of emphasis of matter(s) paragraphs with references to the company's financial statements in specific areas.

Users seem to agree on the two audit report formats that they like the least. No one prefers a one-sentence pass/fail audit report, and users generally do not like a one-sentence audit report containing a score (for example between 0 and 10) on the fairness of the financial statements. With respect to the latter users indicate that it would be difficult to develop criteria for the auditor to create the score. Furthermore, the score would be difficult to interpret by investors (e.g. what does a 7 or an 8 mean?). Finally, users expect management to put pressure on the auditor to increase the score.

[17] For example, disclosing the percentage of fair values, which are based on market values and the percentage of fair values which are calculated by models as well as disclosing to what degree the models are fed with market values versus assumptions.

3.4 Conclusion: Proposed audit reporting model

From the interviews that we conducted with auditors, investors and other financial statement users, we conclude that (1) users want a conclusion on the fairness of the financial statements as is included in the existing audit report but preferably located more in the front of the report; (2) users do not seem to show much interest in how the auditor arrived at his conclusion (e.g. methodology), the composition of the audit team and engagement statistics; (3) users want to be able to rely on the public oversight body, the reputation of the audit network and the audit committee in safeguarding audit quality; (4) users would like to have more information on a number of auditor findings some of which imply an extension of the scope of the audit; (5) users do not attach much value to boilerplate statements included in the audit report; and (6) users indicate that they may benefit from some additional educational material on the scope of the audit and language used in the audit report.

These conclusions supplemented with our own views lead us to propose an audit reporting model structured around the following four main information items:

(1) **Scope of the audit:** listing of items that are part of the audit (e.g., financial statements, management discussion & analysis, internal control). The items that are part of the audit can be determined by what national legislators prescribe and what audit committees voluntarily demand. The latter would allow auditors to respond to variations in user demands. For example, an auditor opinion on the effectiveness of the system of internal control is required under US SOX 404, but is not required in the EU. To explain what an audit of each of the listed elements that are part of the audit entail, reference can be made to educational material which is made available on a website or from another publicly available source. This educational material would serve as a user manual. We note that the availability of such a user manual also results in some responsibilities for the users: just as with any other product or service, one should not use it without having read the user manual.

(2) **Findings of the audit:** the auditor's conclusion on each of the items that are part of the audit. These conclusions should be unequivocal.

(3) **Auditor discussion and analysis:** a discussion and analysis of the auditor's findings on each of the items that are part of the audit. This discussion should be intended to facilitate an understanding of the auditor's conclusion on each of the items that are part of the audit and should not qualify the auditor's conclusion as this would transfer the responsibilities of the auditor to the user.

(4) **Information on the auditor:** reference could be made to the audit firm's transparency report and the report of the public oversight body to facilitate users to form an opinion on the quality of the auditor. Transparency reports are mandatory in a number of countries, including EU countries, for audit firms with public interest entities in their client portfolio. Public oversight bodies report on the quality of audit firms based on their inspections, either publicly (e.g., US, UK) or privately to the audit firms. Some regulators argue that one way to promote audit quality would be to expand transparency with regard to the governance and professional practices of audit firms. Specifically, it is argued that since the governance of audit firms is considered to have a significant influence on audit quality, it is expected that more transparency on audit firm governance may provide insight in firms' audit quality, and as a result may provide incentives for audit firms to compete more directly on audit quality. We note that in a recent study, Deumes et

al. (2011) conclude that the current transparency report disclosure levels do not appear to reveal the underlying audit firm quality. This would be in line with recent recommendations of oversight bodies and the auditing profession encouraging audit firms to further improve the information value of disclosures, rather than giving in-compliance statements which risk becoming uninformative boilerplate statements.

Chapter 4: Research agenda

4.1 Introduction

In this chapter we present an agenda for future research on audit reporting. During the performance of this project (March-June 2011), the IAASB released its consultation paper on enhancing the value of auditor reporting in May and the PCAOB issued its concept release on the audit reporting model in June. Both consultation reports contain the most recent outstanding questions on potential changes to the audit report on which input is sought from different stakeholders such as investors, auditors, preparers of financial statements and audit committee members. We do not reiterate the extensive list of questions contained in these documents in this report and refer to the respective documents for more information on these. Instead, based on our review of the literature and our interviews with auditors and users we have made a selection of what we consider the most important questions to be addressed to further inform the current debate, supplemented with our own ideas for future research to advance our knowledge in this field.

4.2 Suggestions for future research

The research agenda that we propose is to conduct studies in the following areas:

(1) Perceived usefulness, change in decision-making behavior and impact on audit quality of alternative reporting formats

There appears to be a need for a wide-scale research to identify preferences of different stakeholders for different audit reporting formats. The feedback that will be received on the outstanding consultation reports of the IAASB and the PCAOB are likely to provide important insights in this regard.

The first and most obvious research proposal is to examine the perceived usefulness of suggested changes and expansions to the standard audit report. For example, research may look into the perceived usefulness of expanding the standard audit report with each of the alternatives (or combination of alternatives) proposed in the concept release by the PCAOB: (1) An auditor's discussion and analysis; (2) Required and expanded use of emphasis paragraphs; (3) Auditor assurance on other information outside the financial statements; and (4) Clarification of language in the standard audit report. Similarly, research is warranted on the perceived usefulness of the proposed changes by the IAASB on: (1) the format and structure of the standard audit report (e.g., re-position the auditor's opinion); (2) audit reporting on other information in documents containing the audited financial statements (e.g. report on auditing procedures required by ISA 720); (3) auditor commentary on matters significant to users' understanding of the audit or the audited financial statements; (4) an enhanced corporate governance reporting model (e.g., a two-way communication between the audit committee and the auditor); and (5) other assurance or related services on information not within the current scope of the financial statement audit. Also, further research seems warranted on the perceived usefulness of the items included in the framework for extended audit reporting proposed in this report classified into (1) clarification of the scope of the financial statement audit and language in the audit report; (2) information on the audit team and engagement statistics; (3) information on the audit process; (4) further information on the results of the auditor's evaluation of the financial statements and (5) disclosures beyond the scope of the financial statement audit, as well as our proposed reporting model based on discussions of this framework with a limited number of users and auditors. Finally, research may also further look into the perceived usefulness of different existing reporting formats.

Next to the *perceived* usefulness of alternatives for changing the audit reporting model, we need to understand whether, and if so how, each of the suggested changes and expansions to the standard audit report cause material differences in the perceived messages of the audit report and will *actually* affect user decision-making and improve users' judgments and market outcomes. This would allow getting some insights on whether additional discussion in the audit report has information value and could ultimately lead to improved allocation of capital and more efficient capital markets.

Finally, it is relevant to look into whether some of the proposed changes to the audit reporting model would have an impact on auditor behavior, the audit process and ultimately the engagement specific audit quality that is delivered. This can be expected if the proposed changes to the audit report would increase the visibility of audit quality.

(2) Unintended consequences of changes to the audit reporting model

Concerns have been expressed that certain changes to the audit report may lead to unintended consequences. To give some examples of these concerns that may need further research:

- Users of the financial statements and the audit report are not part of the dialogue that has taken place between auditors, management and those charged with governance and may therefore take additional information in the audit report out of context which could lead to suboptimal decision-making. A related issue is the possibility that the disclosure of certain risk exposures will result in a self-fulfilling prophecy.
- Research seems warranted on whether expanding the audit report with the proposed changes and alternatives that are suggested results in confusion and/or misleads users (e.g., resource allocation decisions which are contrary to portfolio preferences) instead of improving the value of the audit report. In other words, do users correctly perceive the intended messages of the audit report, and does this have an effect on decision quality? Experimental research in line with early work on audit reporting could be relevant in this regard (e.g., Libby 1979; Bailey III et al. 1983). Further, do the proposed changes to the audit report actually reduce communication problems that contribute to the expectation and information gap and thus narrow these gaps? Another important question is what level of assurance is derived from the proposed changes to the audit report and in particular, whether the changes lead to greater uncertainty rather than greater assurance.
- One should be cautious that there appears to be a distinction between the perceived usefulness of changes to the audit report and the actual usefulness in practice. In this regard, it is informative to refer to the study by the French CNCC (2011) on the perceived usefulness of the statement of justification of assessments in the audit report. From this it can be concluded that this statement is useful in principle but that there appears to exist a discrepancy between what the justification *could* contribute and what it *effectively* contributes. Furthermore, in the interviews we conducted for this study, auditors indicated that any information that they would disclose which would suggest that management is not fully in control would lead to endless discussions with management, of which the outcome is likely to be boilerplate statements contained in the audit report but with an improvement in

the controls that are in place. Relatedly, it may be interesting to examine whether auditors are less forthcoming with information when stakeholders are provided with legal access to certain communications between the auditor and client management and between the auditor and those charged with governance (see Turner et al. 2010). This would be opposite to what users expect from improving the value of audit reporting.

- A number of other issues to consider related to changing the audit report, some of which are also outlined in the PCAOB concept release and the IAASB consultation paper, are the following: the effects on the interactions between management, the Board, and the auditor (e.g., Does additional public disclosure chill discussions between management, the Board and the auditor, which may make it much harder to do the audit?); confidentiality issues (e.g., Do clients actually want (or allow) the auditor to publicly disclose certain additional information? (see Turner et al. 2010)); the willingness of auditors to publicly disclose their developed proprietary audit methodologies (see IOSCO 2009)); liability issues (e.g., How do additional disclosures affect the risk profiles of the auditor and the client? (see Turner et al. 2010); Do the proposed changes expose auditors to increased litigation if these changes introduce more subjective information that can be second-guessed? (see IOSCO 2009)); the effects on audit committee governance; and the effects on the overall timing and extent of audit effort.

(3) Cost/benefit analysis

Obviously, an important question to deal with is a cost/benefit analysis of the proposed changes to the audit report. As also pointed out by Turner et al. (2010), future research is warranted on potential changes in audit fees resulting from expanded disclosure requirements to assess the balance between the costs and benefits of the proposed changes to the audit report. In addition, it is an open question to what extent there is a willingness to pay for these additional disclosures, and how benefits and costs (including a potential change in audit firms' litigation exposure) are shared by various stakeholders (see also Gray et al. 2011).

(4) Development of educational material

It would be helpful to know what educational material, if any, is needed by users to serve as clarifications of the audit report and help readers understand the audit report and the auditor's responsibilities. For example, what type of educational material (in terms of form and content) would be most helpful to improve users' understanding of issues like the scope of the audit, the nature of assurance, the meaning of different levels of assurance, the concept of materiality and the audit process? With regard to the audit process, we point to the idiosyncratic nature of auditing which may make a standard description of the audit process uninformative (Knechel 2009).

(5) Division of responsibilities

In our opinion, auditors cannot be considered as the 'holy grail' for all transparency needs of users. Auditors are only one of the many different players in the governance of business reporting, besides standard setters, public oversight bodies and audit committees. Hence, future research may look into optimal division of the provision of information between these players. For example, how do audit committee members perceive their role in fulfilling some of the information needs of users? In this regard, the IAASB consultation paper presents an enhanced model of corporate governance reporting under which “the audit committee would issue a report to users of financial statements with information about its oversight of the financial reporting process and the audit” (IAASB, 2011, p.21).

4.3 Conclusion

In this chapter we have made a number of suggestions for future research on auditor reporting which, in our opinion, are relevant to advance our knowledge on the *effects* of changes to the audit report proposed by different parties. Further research seems warranted before regulatory action is undertaken in this regard. We have classified our suggestions for future research into five categories:

(1) Perceived usefulness, change in decision-making behavior and impact on audit quality of alternative reporting formats;
(2) Unintended consequences of changes to the audit reporting model;
(3) Cost/benefit analysis;
(4) Development of educational material;
(5) Division of responsibilities.

Insights on each of these five research areas are likely to provide a basis for regulatory activity, if any, in the area of audit reporting.

Chapter 5: Conclusion

The purpose of this study was to develop a framework for extended audit reporting, and to validate this framework based on discussions with a limited number of stakeholders to develop an agenda for future research.

After reviewing academic and professional literature, we classify potential additional disclosures in the audit report into five categories: (1) clarification of the scope of the financial statement audit and language in the audit report; (2) information on the audit team and engagement statistics; (3) information on the audit process; (4) further information on the results of the auditor's evaluation of the financial statements; and (5) disclosures beyond the scope of the financial statement audit. With regard to the format of the audit report, we distinguish: (1) the existing audit report; (2) a one-sentence "pass/fail" audit report; (3) a one-sentence audit report containing a score on the fairness or quality of the financial statements; (4) the existing audit report supplemented with additional information in an auditor's discussion and analysis section in a free form; (5) the existing audit report with an expanded use of emphasis of matter(s) paragraphs with references to the company's financial statements in specific areas; and (6) the existing audit report with a statement of audit approach as a justification of the auditor's assessment.

We have discussed our framework for extended audit reporting with a limited number of auditors, investors and other users of audited financial statements, and asked their opinion on how the information value of the audit report could be improved. Based on these interviews, we find support for the presence of an information gap but it seems to be a well-articulated one and it is not simply a question of 'The more information, the better'. Specifically, we find that users do not seem to care much about receiving information on the audit process (such as the methodology used by the auditor) and information on the audit team or engagement statistics. In this regard, users want to trust the public oversight bodies, the reputation of the audit firm networks and the audit committee. What we do find, is that users are interested in more disclosure on audit findings such as key areas of risk, quality of the system of internal control, auditor's evaluation of accounting policies and practices (e.g., aggressive or conservative accounting), critical accounting estimates and management judgments. Further, users indicate that changes to the contents of the audit report are more important than changes to the format of the report. Hence, we conclude that changes in the structure and language of the audit report only are not likely to make a significant step forward in enhancing the value of the audit report.

Using the insights obtained from the conducted interviews supplemented with our own views, we propose an audit reporting model structured around four main information items: (1) scope of the audit; (2) findings of the audit; (3) auditor discussion and analysis; and (4) information on the auditor.

This proposed framework may be a first step in reducing the information gap. At the same time, we recognize that the global complex business environment of today presents new challenges to corporate reporting and meeting information demands of users. Corporate transparency is of economic importance as it contributes to a more efficient resource allocation (Francis et al. 2009). Hence, to make a significant step forward in audit reporting, we conclude that this should go hand in hand with a change in the corporate reporting model, of which financial reporting is one, albeit major, component. This will most likely imply an extension of the scope of the audit and possibly also a change in the frequency of reporting. Our interviews with auditors show that auditors are also fully aware of this: the auditing profession exists to serve the public interest and if society demands a different corporate reporting model, then auditors have to respond and facilitate this demand to enhance the value of the audit. This is also in line with earlier findings of MARC (2010a) indicating that CFOs and audit committee members would like to see the audit model reconsidered to offer a less compliance driven, but a more comprehensive approach that additionally offers a broader, more holistic view of the business. Integrating reporting and assurance may therefore be the way forward as it is a "holistic approach integrating both material financial and non-financial information and is structured around the organization's strategic objectives, its governance and business model" (FEE 2011).

Before embarking on such a fundamental reform, careful consideration should be given to a number of issues, some of which can be addressed by academic research, while others need attention from standard setters and regulators. We have listed a number of issues for future research in chapter 4. Future research is recommended since ultimately the purpose is to enhance the value of the audit report as a means to meet user information needs to improve decision making and to avoid unintended consequences including misunderstanding and confusion leading to inappropriate decisions.

Finally, we would like to emphasize that the auditor cannot be considered as the 'holy grail' to meet all information demands of users. Auditors are only one of the many different players in the governance of business reporting, besides standard setters, public oversight bodies and audit committees. As pointed out in the response by MARC (2010b) to the EC Green Paper on Audit Policy, it would be desirable if audit committees more fully take up their responsibilities set out in the Eighth EU Directive and play a more prominent role in the supervision of the audit function (i.e. selection and monitoring). To accomplish this, it is important that the incentives of the audit committee are properly aligned with the stakeholders that they represent rather than management who may have direct access to, and influence over, the committee. Further, we must not forget that it is management that is ultimately responsible to provide stakeholders with the information they need. This responsibility cannot simply be transferred to standard setters, regulators, public oversight bodies, auditors or any other governance mechanism.

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Appendix A: Interview structure for auditors

1. How do you assess the information value of the audit report in its present form for investors or stakeholders in general? (Scale 1 to 10, where 1 = very weak and 10 = very strong)

2. In your opinion, can the information value of the audit report be improved? (Yes/No)

3. In your opinion, would additional disclosures on the following items in the audit report improve the information value of the audit report?

   I. Clarification of the scope of the financial statement audit and language in the audit report
   e.g., clarification of level of assurance; auditor's responsibility with regard to fraud; auditor's responsibility regarding disclosures beyond traditional financial statement disclosures; auditor's responsibility with regard to the director's report; auditor's responsibility with regard to the operational and financial review; identification of other items outside the scope of the financial statement audit.

   II. Information on the audit team and engagement statistics
   e.g., engagement partner's name and signature; auditing experience of the engagement partner; industry experience of the engagement partner; audit team composition and proportion of time spent on engagement by each staff level; involvement of specialists and proportion of time spent on the engagement by specialists and for which areas; importance of client to audit firm and office (revenues); auditor independence issues.

   III. Information on the audit process
   e.g., general risk assessment of the client company; assessment of risk of material misstatement (due to accounting practices, policies, procedures; accounting estimates and judgment; material assumptions; internal controls); assessment and sources of detection risk (level of materiality used for the engagement; components directly verified; components verified on the basis of professional judgment, internal models, assumptions, and/or management explanations; extent of reliance on internal controls; information on the use of sampling); audit implications of disclosures beyond traditional financial statement disclosures.

   IV. Further information on the results of the auditor's evaluation of the financial statements
   e.g., quality of the financial statements; quality of the internal control system; likelihood of fraud and illegal acts; going concern assessment; broad assessment of the sustainability of the business; information on communication with those charged with governance (such as significant difficulties encountered during the audit, disagreements with management, extent of interaction with those charged with governance; percentage of waived and adjusted misstatements; additional information disclosed in management letter.

   V. Disclosures beyond the scope of the financial statement audit
   e.g., provision of holistic view of client's business; forward-looking, qualitative and/or nonfinancial client information; IAASB items.

4. What type of additional disclosures mentioned above would you be willing (and able) to provide without much problem?

5. What type of additional disclosures mentioned above do you find more problematic to provide, and why? Under what conditions would you be willing to provide this information?

6. In your opinion, what other disclosures (other than the ones mentioned above) can improve the information value of the audit report?

7. In your opinion, can the value of the audit be improved by extending the scope of the audit (e.g., some type of assurance on MD&A, some type of assurance on an expanded audit committee report)? If yes, how?

8. The IAASB has recently issued a discussion paper on "The evolving nature of financial reporting: disclosure and its audit implications". What is your opinion on the current financial reporting disclosure trends, the increasing complexity of financial reporting requirements, and the demand of users for disclosures not specifically required by the financial reporting framework, and the implications for the audit?

9. a. In your opinion, what is the most appropriate audit report format to offer these additional disclosures? Examples:
   - The current, existing audit report;
   - A one-sentence "pass/fail" audit report;
   - The existing audit report supplemented with additional information in an auditor's discussion and analysis section in a free form;
   - The existing audit report with an expanded use of emphasis of matter(s) paragraphs with references to the company's financial statements in specific areas; and
   - The existing audit report with a statement of audit approach as a justification of the auditor's assessment (e.g., discussing the critical judgments made in forming the auditor's opinion and the key audit procedures performed by the auditor with regard to these judgments and reference to the related disclosures in the financial statements), in line with the current French audit report format.

   b. Would you find a score (for example between 0 and 10) on the fairness of the financial statements more informative than the existing "pass/fail" audit report? (Yes/No)

Appendix B: Interview structure for users

1. In what capacity do you make use of the financial statements and the related audit report?

2. How do you assess the information value of the audit report in its present form? (on a scale from 1 to 10, where 1 = very weak and 10 = very strong)

3. In your opinion, can the information value of the audit report be improved? (Yes/No)

4. In your opinion, would additional disclosures on the following items in the audit report improve the information value of the audit report?

   I. Clarification of the scope of the financial statement audit and language in the audit report
   e.g., clarification of level of assurance; auditor's responsibility with regard to fraud; auditor's responsibility regarding disclosures beyond traditional financial statement disclosures; auditor's responsibility with regard to the director's report; auditor's responsibility with regard to the operational and financial review; identification of other items outside the scope of the financial statement audit.

   II. Information on the audit team and engagement statistics
   e.g., engagement partner's name and signature; auditing experience of the engagement partner; industry experience of the engagement partner; audit team composition and proportion of time spent on engagement by each staff level; involvement of specialists and proportion of time spent on the engagement by specialists and for which areas; importance of client to audit firm and office (revenues); auditor independence issues.

   III. Information on the audit process
   e.g., general risk assessment of the client company; assessment of risk of material misstatement (due to accounting practices, policies, procedures; accounting estimates and judgment; material assumptions; internal controls); assessment and sources of detection risk (level of materiality used for the engagement; components directly verified; components verified on the basis of professional judgment, internal models, assumptions, and/or management explanations; extent of reliance on internal controls; information on the use of sampling); audit implications of disclosures beyond traditional financial statement disclosures.

   IV. Further information on the results of the auditor's evaluation of the financial statements
   e.g., quality of the financial statements; quality of the internal control system; likelihood of fraud and illegal acts; going concern assessment; broad assessment of the sustainability of the business; information on communication with those charged with governance (such as significant difficulties encountered during the audit, disagreements with management, extent of interaction with those charged with governance; percentage of waived and adjusted misstatements; additional information disclosed in management letter.

V. **Disclosures beyond the scope of the financial statement audit**
   e.g., provision of holistic view of client's business; forward-looking, qualitative and/or nonfinancial client information; IAASB items.

5. In your opinion, what other disclosures (than the ones mentioned above) can improve the information value of the audit report?

6. In your opinion, can the value of the audit be improved by extending the scope of the audit (e.g., some type of assurance on MD&A, some type of assurance on an expanded audit committee report)? If yes, how?

7. Would you find a score (for example between 0 and 10) on the fairness of the financial statements more informative than the existing "pass/fail" audit report? (Yes/No)

8. Which of the following types of audit report formats would you prefer the most and why (multiple options are possible)?
   a. The existing audit report.
   b. A one-sentence "pass/fail" audit report.
   c. A one-sentence audit report containing a score (for example between 0 and 10) on the fairness of the financial statements.
   d. The existing audit report supplemented with additional information in an auditor's discussion and analysis section in a free form.
   e. The existing audit report with an expanded use of emphasis of matter(s) paragraphs with references to the company's financial statements in specific areas.
   f. The existing audit report with a statement of audit approach as a justification of the auditor's assessment (e.g., discussing the critical judgments made in forming the auditor's opinion and the key audit procedures performed by the auditor with regard to these judgments and reference to the related disclosures in the financial statements), in line with the current French audit report format.
   g. Other: please specify.

9. Which of the following types of audit reports would you prefer the least and why (multiple options are possible)?
   a. The existing audit report.
   b. A one-sentence "pass/fail" audit report.
   c. A one-sentence audit report containing a score (for example between 0 and 10) on the fairness of the financial statements.
   d. The existing audit report supplemented with additional information in an auditor's discussion and analysis section in a free form.
   e. The existing audit report with an expanded use of emphasis of matter(s) paragraphs with references to the company's financial statements in specific areas.
   f. The existing audit report with a statement of audit approach as a justification of the auditor's assessment (e.g., discussing the critical judgments made in forming the auditor's opinion and the key audit procedures performed by the auditor with regard to these judgments and

reference to the related disclosures in the financial statements), in line with the current French audit report format.

g. Other: please specify.