Comments prepared for the PCAOB Public Meeting on the Auditor's Reporting Model
April 2, 2014
By Theodore J. Mock, Distinguished Professor of Audit & Assurance
University of Californian, Riverside

Background

My comments today are founded on research I have personally conducted, and the citations are found at the end of this comment. Most important are a series of research efforts that were motivated by collaborative efforts by the AAA Audit Section and the PCAOB to provide a research synthesis relevant to PCAOB initiative concerning possible enhancements to the Auditor's Reporting Model. The most relevant are the research literature synthesis submitted to the PCAOB (Mock et al. 2012 and 2013), two formal comment letters submitted to the PCAOB and IAASB (Bédard et al., 2013a, 2013b), and a recent paper which updates the research synthesis (Mock et al. 2014). Although these comments are my own, I am indebted to the research synthesis team, particularly Jean Bédard, Université Laval; Paul Coram, University of Melbourne; Reza Espahbodi, Washburn University and Rick Warne, George Mason University for the underlying research and ideas which go into my comment.

I would like to highlight the critical importance of the PCAOB in supporting the work of the academic community by, among other things, formally considering academic research in all of their activities. The PCAOB also should be commended for other initiatives such as its Annual Academic Conference. I believe I represent the entire audit research community in thanking you for this.

Primary objectives of my comments:

My main goal is to address today's main topic, that is to consider "…the need for change to the auditor's report" and our panel's specific charge to "explore changes to the auditor's report from different perspectives" I was specifically asked to focus "on the proposed changes to the auditor's report based on relevant academic research."

This latter objective was addressed in our papers and comments by reviewing prior published research and addressing three research questions:

RQ 1: What specific information do investors and other stakeholders want to be included in the auditor's report?

RQ 2: How do investors and other stakeholders use proposed additional auditor communications in their decision making?

RQ3: To what extent can the proposed disclosures be expected to close the communication and information gaps?

The research framework underlying our analysis is based in Communication Theory, in particular on two elements of the “Expectations Gap” designated as “information and communications gaps” [See Exhibit 1]. The sample we reviewed in our work included approximately 130 published research projects conducted between 2007 and 2013 and built on the considerable body of research synthesized by Church et al. (2008).

Key Findings Based on Published Research

There are three overall findings I would like to highlight:

1. Users of financial statements do not appear to carefully evaluate the current standard audit report because it is such a standardized product. That is, standard unqualified audit reports are viewed to be essentially the same. However, reports that augment the standard audit report with information such as going concern uncertainties and internal control weaknesses do seem to contain additional relevant content.
2. Users do seem to want more information on risk, materiality, and other information surrounding the specific audit. In particular, users are more interested in information about the audit (e.g. risks, materiality) rather than information about the audit process (e.g. audit hours).
3. While significant research exists in many areas, there are many areas where a ‘”research gap” exists, that is where there seems to be a lack of sufficient research evidence.

This research evidence gap suggests the need for the PCAOB to work even more closely with the auditing research community and to provide or facilitate increased support to audit researchers. Such further research could provide more definitive conclusions regarding proposed changes to the current auditor’s reporting model.

Some Observations Based on More Recent, Mostly Unpublished, Academic Research.

A look at more current academic research, including working papers, finds more research which is directly relevant to the more innovative aspects of the PCAOB proposals, including “Critical Audit Matters (CAMs).” For example, in our research synthesis (Mock et al. 2013. p. 344) we report that research has shown that “going concern information, internal control reports, and unregulated assurance reports provide more variability in the types of communications, which appears beneficial to financial statement users.” Current PCAOB proposals related to CAMs similarly would provide more reporting variability and thus exhibit a potential to make the audit report less “boilerplate.” A working paper (Bédard et al. 2013c) summarizes recent research including their empirical study on the reporting of Key Audit Matters (IAASB). The Bédard et al. study suggests that CAMs may have the potential to be valuable to users through an attention-directing role and may reduce information asymmetry. However, their empirical research indicates that auditor justification of assessments, which have been mandatory in France since 2003, has not had discernible market effects. Whether a standard that requires communications such as CAMs is valuable is also an empirical question, but a question that cannot be completely addressed until the requirement is in effect for a sufficient time period.

Limitations and Conclusion

Similar to a financial statement, one should not draw solely from the "bottom line" summaries in this formal comment, but should consider the details provided in various referenced reports and comment letters. The research we have synthesized has both research methods limitations and sampling limitations. And, there is no generally-accepted research synthesis methodology. Similar to auditing itself, it is unclear when a body of research provides enough competent research for us to reach a research conclusion with a high level of assurance. Lastly, much of the research does not explicitly account for litigation risks or costs-versus-benefits in general.

To conclude with perhaps the most important finding from our review: Academic research is fairly consistent across different research methods, time periods, and economic settings in suggesting that an important way to improve the communicative value of the current audit reporting model is if it is not "boilerplate." That is, the audit report should provide different information across clients about the audit that has been conducted. Thus, facilitating additional audit report content, such as discussion of critical audit matters, would seem to be beneficial.

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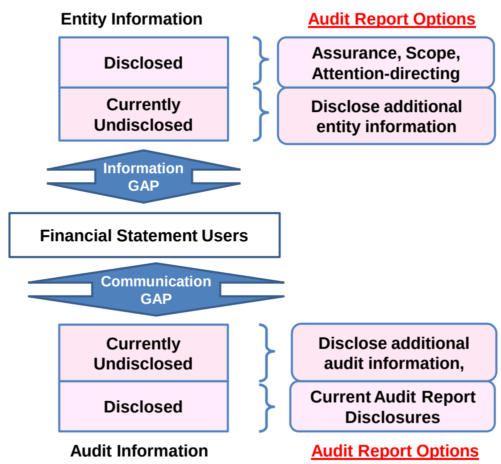
Exhibit 1: Research Synthesis Framework



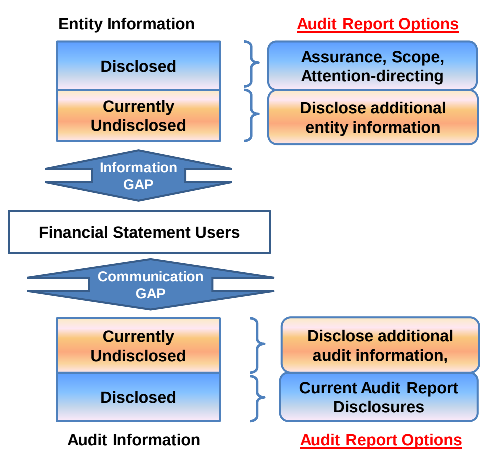
Comments Concerning Academic Research Relevant to the Auditor's Reporting Model

Theodore J. Mock
Distinguished Professor of Audit & Assurance,
University of California, Riverside

PCAOB Public Meeting on the Auditor's Reporting Model

April 2-3, 2014

Washington, DC



Content

Background

- Research sponsored by the AICPA ASB and IAASB
- Synthesis Research motivated by the AAA Audit Section
- The *Comment Team:*
  - Jean Bédard, Université Laval
  - Paul Coram, University of Melbourne
  - Reza Espahbodi, Washburn University
  - Rick Warne, George Mason University

Primary Objective, Research Questions and Framework

- Focus “on the proposed changes to the auditor's report <u>based on relevant academic research</u>
- Objective addressed by considering 3 RQs
  1. What information do stakeholders want to be included in the auditor's report?
  2. How do stakeholders use auditor communications in their decision making?
  3. Can the proposed disclosures be expected to close the communication and information gaps?
- Research synthesis framework is based in Communication Theory

Key Findings Based on Published Research

- Users of financial statements do not appear to carefully evaluate the current standard audit report because it is such a standardized product.

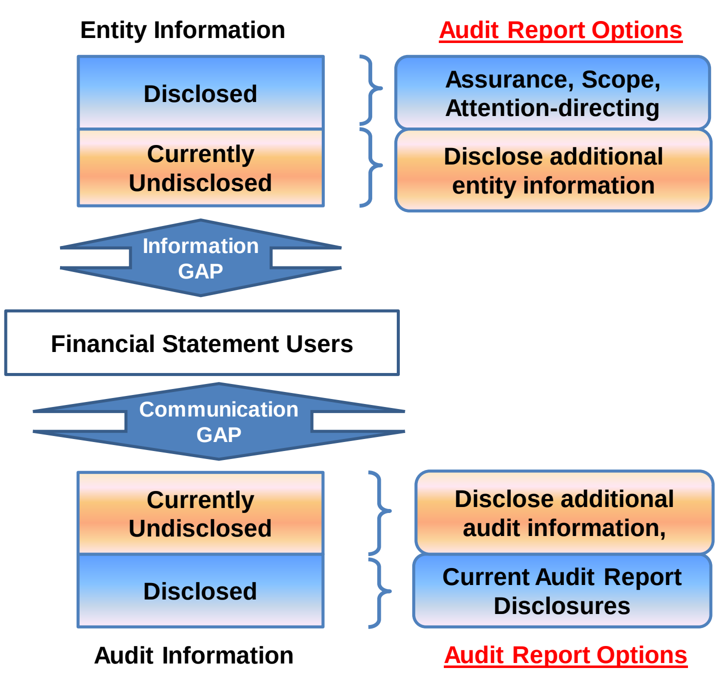
- Users do seem to want more information on risk, materiality, and other information surrounding the specific audit.
- There are many areas where a '"research gap" exists, that is where there seems to be a lack of sufficient research evidence

Limitations and Conclusion

- **Limitations:**
  - "Bottom line" summaries of published research.
  - Research methods and sampling limitations
  - When a body of research is conclusive
  - Research often does not account for certain risks or costs-versus-benefits
- **Conclusion**: **Academic research is fairly consistent across different research methods, time periods, and economic settings in suggesting that an important way to improve the communicative value of the current audit reporting model is if it is not "boilerplate."**

Appendix

- References [See Comment]
- Research Synthesis Framework



Does academic research provide sufficient, competent evidence concerning possible changes to the audit reporting model?

March 3, 2014

Theodore J. Mock
University of California, Riverside

Jean Bédard
Université Laval

Paul Coram
University of Melbourne

Reza Espahbodi
Washburn University

Rick C. Warne
George Mason University

*Note: This article is based partly on a synthesis of the literature on the audit reporting model (Mock, Bédard, Coram, Davis, Espahbodi, and Warne 2013) and comment letters submitted by Bédard, Coram, Espahbodi, Mock and Warne (2013a; 2013b) to the PCAOB and IAASB. It is written by a subset of the synthesis authors and expresses the views of these authors alone.

Does academic research provide sufficient, competent evidence concerning possible changes to the audit reporting model?

Synopsis

The Public Company Accounting Oversight Board (PCAOB) and the International Auditing and Assurance Standards Board (IAASB) have each proposed a standard that could significantly change the independent auditor's report. Both proposed standards would require the auditor to make additional disclosures intended to close possible information and communication gaps and, in general, improve the relevancy of the auditor's report. Clearly, changes to the auditor's report could have significant consequences to financial market participants and other stakeholders.

We review prior academic research related to the PCAOB and IAASB proposed standards with the intent of assessing the extent to which prior research provides sufficient, competent evidence for standard setters in their assessments of whether the proposed changes are likely to close the communication and information gaps. While significant research exists in many areas, we identify many areas where there seems to be a lack of sufficient research evidence.

These results should interest standard setters as they consider fundamental changes to the auditor's report and also as they consider ways of stimulating future relevant academic research. Additionally, our summaries that indicate limited research or inconsistent results should help academics identify important opportunities for future research to provide relevant research for the standard setting process.

Does academic research provide sufficient, competent evidence concerning possible changes to the audit reporting model?

INTRODUCTION AND OBJECTIVES

The auditor's report, which usually provides a standard unqualified opinion, has been the subject of long-standing discussions and debates concerning its form, content, and value (e.g., Commission on Auditor's Responsibilities 1978; Geiger 1993; Smieliauskas et al. 2008; Church et al. 2008, Mock et al. 2013). However, the content and structure of the auditor's report has changed little since the 1980s, and the pressure to change it continues to mount.

Given these pressures, the PCAOB and IAASB each have proposed a standard which incorporates important changes to the auditor's report for the financial statement audit (PCAOB 2013; IAASB 2013).[1] Most importantly, both standards call for:

- A new section in the audit report describing the matters the auditor determined to be of most significance in the audit ("Critical/Key Audit Matters")[2]
- Additional procedures for the auditor to perform to evaluate the "other information" in the annual report and expression of the auditor's conclusion regarding the outcome in a new section
- An explicit statement regarding the auditor's independence and the sources of the independence requirements

Each proposed standard imposes additional requirements on the auditor. For example, the PCAOB standard would add new elements to the auditor's report related to auditor tenure, and enhance certain standardized language in the report. The proposed IAASB standard would add a new section in the audit report making

[1] In this article when discussing changes that are common to both the PCAOB and IAASB, we refer to the "standard setters" and the "proposed standards" or "exposure drafts."

[2] The PCAOB proposal requires the auditor to identify critical audit matters (CAMs) while the IAASB requires the auditor to disclose key audit matters (KAMs). For ease of exposition, we elect to use the term CAM throughout this analysis except to reference the specific IAASB proposed standard.

explicit the auditor's conclusions on the appropriateness of management's use of the going concern basis of accounting and on material uncertainties. Furthermore, the IAASB exposure draft requires identification of the engagement partner's name.

Financial statement users, regulators, and audit oversight bodies have called for increased transparency regarding the financial statements and the audit, and these proposed changes are the standard setters' responses to requests for more information from the auditor. In their exposure drafts, the PCAOB and the IAASB list several benefits and other effects of the proposed standards where prior audit research may provide insights regarding their likelihood of being realized. These include:

- Enhanced informativeness (communicative value) of the auditor's report, and more transparency about the audit that was performed, thus potentially increasing its relevance and usefulness to investors and other financial statement users
- Renewed focus of the auditor on critical matters that arise during the audit, which could indirectly result in an increase in professional skepticism among other contributors to audit quality

In summary, the proposed standards require the disclosure of additional information highlighting matters that, as indicated in prior research, are important to users' understandings of audited financial statements. Furthermore, the additional disclosures could affect the auditor and nature of the audit. In Figure 1 below, we present disclosures that may help reduce the information and communication gaps associated with the audit process.

This article adds to the academic research concerning the standard audit report (Mock et al. 2013) in two important ways. First, we provide an updated synthesis of academic research and consider new aspects such as the proposed CAM disclosures. With the possibility of the auditor's report significantly changing, our analysis should help researchers better understand where important research opportunities remain. Second and more importantly, we consider both of the initiatives by the PCAOB and the IAASB. This update should also help other standard setting bodies understand where academic research provides evidence related to their proposals and where the research is either mixed or non-existent. Thus, we review prior research with the objective of assessing whether or not the proposed additional audit report communications of each initiative is likely to close the information and communication gaps.

However, standard setting is an iterative process full of discussion and often controversy.[3] Regardless of any changes implemented by the IAASB and the PCAOB in the near future, many of the gaps can be expected to remain at least partly unfulfilled, and some of the questions and issues discussed in the literature and in this paper will persist for years to come. Thus, we also identify significant research gaps where prior literature does not sufficiently inform standard setters, and we suggest important opportunities for future research to provide the evidential support for this standard setting process. We call on academics and standard setters to work together to address important issues surrounding the auditor's report.

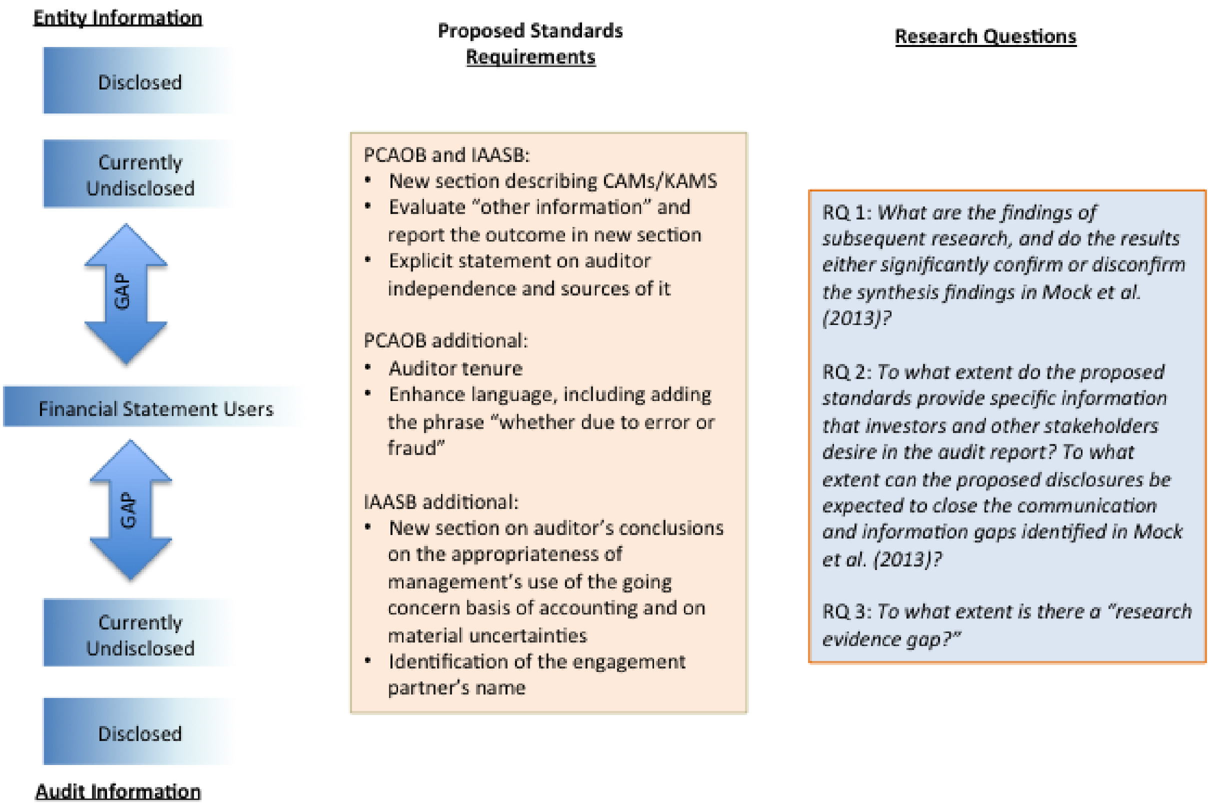
FRAMEWORK, APPROACH AND RESEARCH QUESTIONS (RQs)

Mock et al. (2013) utilize communication theory to describe the audit process and components of the auditor's report, resulting in the framework shown in Figure 1. A common problem with the auditing process is the *expectation gap.* This framework disaggregates the *expectation gap* into two key factors: an *information gap*, which

[3] For example, the PCAOB received 237 comment letters for the proposal entitled, "Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments."

relates to information about the audit client, and the *communication gap*, which relates to information about the audit process and the auditor. Figure 1 modifies the Mock et al. (2013) framework to highlight the requirements of the proposed standards and our research questions.

Figure 1: Information and Communication Gaps, Proposed Standards, and Research Questions



Below in our analysis, we focus on three Research Questions (RQs) that we believe are most relevant to standard setters, who are contemplating additional requirements for auditors, and academic researchers, who are trying to investigate critical research questions for the auditing profession. Our research questions are as follows:

> RQ 1: *What are the findings of subsequent research, and do the results either significantly confirm or disconfirm the synthesis findings in Mock et al. (2013)?*
>
> RQ 2: *To what extent do the proposed standards provide specific information that investors and other stakeholders desire in the audit report? To what*

extent can the proposed disclosures be expected to close the communication and information gaps identified in Mock et al. (2013)?

RQ 3: *To what extent is there a "research evidence gap?"*

FINDINGS WITH RESPECT TO RQ 1

The Mock et al. (2013) synthesis builds on a prior literature review conducted by Church, Davis, and McCracken (2008) and analyses approximately 90 projects conducted between 2007 and 2011. In the current analysis, we consider an additional 40 research studies and determine whether the prior synthesis findings are confirmed (i.e., strengthened) or possibly disconfirmed (i.e., weakened.) As some of these studies relate to settings or issues that are not directly related to topics included in the PCAOB and IAASB proposed standards, we do not include such research in our analysis.

What Specific Information Do Investors and Other Stakeholders Want Included in the Audit Report?

Mock et al. (2013) summarize prior research with respect to stakeholders' desired information in the audit report. The results indicate that stakeholders find value in the audit report, but they desire additional information related to the audit process, the auditor, and the financial statements. Such additional desired disclosures include information about the audit process, materiality levels, the client's accounting policies, and specific information related to client risk.

Two recent studies examine the information desired by financial statement users. Carcello (2012) surveys over 300 diverse and knowledgeable financial statement users. The results indicate that 91% of participants did not read the standard audit report, and 18% reported that the auditor's report is useless. Participants also express a desire for more information from the auditor. For example, 79% of survey participants desire greater disclosures regarding management's significant judgments and estimates. Also, 77% want more auditor disclosures related to risk. Overall, the results indicate that a sizeable majority of experienced financial statement users request more disclosures from the auditor.

Vanstraelen et al. (2012) conduct semi-structured interviews with a small number of auditors and professional financial statement users to assess the information gap associated with the auditor's report. Results indicate that neither auditors nor financial statement users want the auditor to release engagement statistics or information about the audit process. However, financial statement users state a desire for more information related to the entity's risks and internal controls. Furthermore, they express a desire for the auditor to provide an "evaluation of accounting policies and practices, critical accounting estimates, and accounting judgments" (p. 207).

Overall, the findings from the Carcello (2012) and Vanstraelen et al. (2012) studies are broadly consistent with Mock et al. (2013). That is, users want more information about the audit. However, one difference noted by Vanstraelen et al. was that more information about the audit process was not particularly important to either group that they studied.

How Do Investors and Other Stakeholders Use and React to Existing and Other Auditor Communications Currently Being Proposed?

Many prior studies have investigated the above research question using archival, survey, interview, focus group, and verbal protocol methods. In their synthesis, Mock et al. (2013, p. 333) categorized research into the following areas:

1) The impacts of information currently included in standard audit reports;

2) The impacts of information included in other types of assurance reports;

3) The effects of auditor’s association with MD&A or other information outside the financial statements;
4) Additional auditor report content explicitly contained in PCAOB Release No. 2011-003; and
5) The engagement partner signing the audit report or being individually identified otherwise.

Recent research has examined issues related to four of the above five categories. We summarize these studies and discuss their impact on Mock et al.’s findings below. In addition, we discuss the results of studies that have examined Mandatory Audit Firm Rotation/Audit Tenure and disclosure of “Critical or Key Audit Matters,” two categories not covered in Mock et al. synthesis, but that are included in the proposed standards.

The Impact of Information Currently Included in a Standard Public Company Audit Report

Prior research reviewed by Mock et al. (2013) suggests that investors noticed changes to the auditor’s report from the 1980s that described managers’ and auditors’ responsibilities. However, the impact of these changes is limited because a significant audit expectation gap still exists. Surprisingly, these changes may have exacerbated the expectation gap according to prior research. Even more detailed explanations, such as those contained in the International Standard on Auditing (ISA) 700 report, do not appear to improve the information communicated by the audit report.

A recent study by Gold et al. (2012) generally supports the above conclusions. Indeed, in their study of the effect of the new ISA 700 auditor’s report on German auditors and financial statement users, Gold et al. (2012) find that detailed descriptions of auditors' and mangers' responsibilities do not reduce the expectations gap. The authors conclude, "*This observation may indicate that the explanations would need to be formulated more explicitly and clearly, or even that users' perceptions are simply not malleable by additional information and explanations in the auditor's report*" (p. 287).

The Impacts of Information Currently Included in Other Types of Assurance Reports

Previous research reviewed by Mock et al. (2013) focuses mainly on the going concern modification, internal control reporting under SOX 404, and assurance reports on sustainability. They conclude that unless "new" information is provided in the audit report, a going concern audit report does not appear to have information content. The exception they note is the paper by Menon and Williams (2010). However, recent research suggests that the auditor's opinion regarding internal controls over financial reporting provides important information to the financial markets. Other assurance reports, such as reports regarding sustainability, may provide value to financial statement users as well.

Our focus in this paper is on the going concern opinion, the only one of the above topics addressed by the proposed standards. We identify seven articles related to the going concern assumption published since the Mock et al. synthesis. Whereas four of these studies investigate the decision to include an emphasis of matter paragraph in the auditor report, three are related to the impacts of going concern information. For U.S. public companies, Kaplan and Williams (2013) examine whether issuing a going concern report to financially stressed clients protects auditors from litigation. They find that for financially stressed clients, going concern reports significantly deter investors from suing auditors and reduce the likelihood of paying a financial settlement in excess of $2 million.

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

Overall, the findings from the above studies are broadly consistent with Mock et al. (2013) who find the value of going concern audit reports to be somewhat mixed. While earlier published archival papers question the value of the auditor’s going concern opinion unless new information is provided, a more recent paper by Menon and Williams (2010) finds such opinions useful to the market. The above recent research does seem to suggest value in these reports. Additionally, a reasonable inference is that if a modified audit report questioning the going concern assumption provides benefit to investors, then commenting on the going concern assumption under *all* circumstances may provide value as well. The existing archival research does not address the value of positive assurance on the going concern assumption when the auditor concludes the going concern assumption is appropriate.

Additional Auditor Report Content: Critical/Key Audit Matters

Mock et al. (2013) highlight a lack of research evidence on "auditor's discussion and analysis" or on "auditor commentary." However, the standard setters decided against this specific type of disclosure by auditors and instead decided that auditors communicate critical/key audit matters (CAMs).

The closest examples in practice of these types of disclosures are the "justifications of assessments" in France. A recent study by Bédard and Gonthier (2013) provides information on the nature of the disclosure of justifications of assessment by French auditors. For the 40 largest French companies, they find that auditors disclose an average of 3.2 critical matters per audit report, and that accounting estimates are the most frequent matters referred to in the report followed by disclosures on accounting methods. They also find that over the eight years studied, only 20 percent of the matters disclosed in the audit report were new matters. The other 80 percent were repeat disclosures and usually a simple "cut and paste" of the previous year's description of the critical audit matters.

Two other studies investigate how users react to disclosure of CAMs. Kristensen et al. (2013) examine how nonprofessional investors react to a CAM paragraph in the audit report. They find that investors are more likely to stop considering a company as an investment when provided a CAM paragraph that reports significant estimation uncertainty, as compared to investors who receive a standard audit report (an information effect) or investors who receive the CAM paragraph in management's footnotes (a placement effect). They also find that the effect of a standalone CAM paragraph is reversed when it is followed by a paragraph offering assurance for the CAM. Sirois et al. (2013) in an experiment using eye-tracking technology examine whether and how additional information in the audit report affect how users navigate and integrate the information presented in the related audited financial statements. They find that matters mentioned in the audit report affect the participants' information searches and increase their attention to financial statement disclosures mentioned in the audit report. However, those matters seem to affect users' perceptions of the audit. In other words, the communication of additional information is associated with a lower perceived value of the audit and a perception that the degree of assurance provided by the auditor differs across components of the financial statements.

These behavioral studies (Kristensen et al. 2013 and Sirois et al. 2013) suggest that there is value in this type of enhanced disclosure to improve the informativeness of the audit report. However, what is not known is how investors will react to this type of information after several years of disclosure or if it becomes "standard" as the evidence from the French example reported in Bédard and Gonthier (2013) shows is a possible outcome from this type of change.

The engagement partner signing the audit report or being individually identified otherwise

Mock et al. (2013) highlight a lack of audit evidence on this topic and reference a commentary by King et al. (2012) that applies insights from three academic frameworks of source credibility, accountability, and the theory of affordances. King et al. note that there may be unintended consequences from the proposed changes in this area. While they find that the changes will increase perceived audit quality, they highlight that there is scarce empirical evidence on whether the changes will increase audit quality in actuality.

In a recent study to address this question, Carcello and Li (2013) examine a number of consequences associated with the engagement partner signing the audit report in the United Kingdom. The results indicate higher audit fees as a result of the requirement, but also higher audit quality and earnings information. The authors also compare a sample of U.K. firms with a sample of similar U.S. firms, and the results suggest higher audit quality related to the audit partner signature.

In another study, Lambert et al. (2013) provide experienced investor participants with summary information on several investment options and find that prospective investors are less likely to invest in a peer firm linked to a restating firm via audit partner name disclosure. The audit report modification language does not appear to alleviate this effect.

These two studies do suggest possible benefits related to the audit partner signing their name; however, the research generally does not address the question of whether the benefits exceed the costs. Along these lines, Mock et al. (2013) note that many countries around the world have had this requirement for years with no apparent adverse effects.[4]

Mandatory Audit Firm Rotation/Audit Tenure

Prior academic research documents possible advantages and disadvantages of mandatory audit firm rotation (e.g., Stefaniak et al. 2009). Possible advantages include auditors becoming more independent in fact and/or in appearance, and increased access of smaller audit firms into the audit market. Possible disadvantages include less questioning of management by auditors, a loss of client-specific audit information which could lead to an audit failure, increased costs, and a greater concentration of large audit firms (Ewelt-Knauer et al. 2012).

[4] Prior research has not examined the potential litigation consequences of this requirement, which may be a significant concern since the U.S. legal environment is significantly different than the legal environments in countries already requiring the audit partner signature.

Though prior research has investigated the topic of mandatory audit firm rotation, it is difficult to draw conclusive public-policy recommendations for at least three reasons. First, as noted by Li (2010), most studies in this area suffer from an endogeneity problem, such as a self-selection bias of firms who voluntarily switch auditors. Second, the research findings are mixed, both among academic studies and often within specific studies. Finally, the research often examines samples of non-U.S. companies, which might have characteristics differing from U.S. companies.

Casterella and Johnston (2013) and Ewelt-Knauer et al. (2012) synthesize the academic literature regarding mandatory audit firm rotation. Casterella and Johnston (2013) caution that the use of academic research results may not generalize into the setting of mandatory audit firm rotation in the U.S. However, they find that 8 of the 11 studies conducted in a mandatory rotation setting provide evidence that lends support to a mandatory rotation policy. Ewelt-Knauer et al. (2012) note that findings are inconclusive with respect to the trade-off between costs and benefits and conclude, “Given the lack of evidence linking mandatory rotation with an improvement in audit quality, regulators need to carefully determine the long-term objectives of a mandatory rotation requirement before implementing a costly measure” (p. 9).

Summary

The results of the recent academic papers largely support the findings of Mock et al. (2013). Recent research documents that investors continue to desire additional disclosures from the auditor specifically related to the financial statements, the audit, and the auditor. Questions persist regarding the value of the current standard audit report. With regards to the auditor’s going concern opinion, Mock et al. (2013) note that earlier published archival papers question the value of the auditor's going concern opinion while later papers find such opinions useful to the market. The recent research discussed above provides more evidence that financial statement users find the auditor's going concern opinion useful. Mock et al. (2013) report little empirical evidence regarding the effects of an engagement partner's signature on the audit report. However as noted above, Carcello and Li (2013) find that such a requirement is related to improved audit quality but also to increased fees. Additionally, Lambert et al. (2013) show that audit partner disclosure affects experienced investors' decisions. Finally, Mock et al. (2013) report that the provision of assurance on MD&A presentations—at least on the verifiable components such as financial information, key resources, and risks—is perceived to be value-relevant. No recent research has examined this issue, although some recent research has examined related issues of CAMs as noted below.

With respect to Audit Firm Rotation/Auditor Tenure and disclosure of CAMs, the two categories not covered in Mock et al., research lends some support to a mandatory rotation policy because audit quality during an audit is lowest in the earlier years (due to knowledge problems) and in the later years (due to independence problems). Prior research, however, does not give a definitive answer on the point at which independence becomes a threat to audit quality, and it also does not fully consider the costs associated with this policy. CAMs mentioned in the audit report seem to affect the participants' information searches and increase their attention to financial statement disclosures mentioned in the audit report. These matters also seem to affect users' perceptions of the value of the audit and the degree of assurance provided by various components of the financial statements.

FINDINGS WITH RESPECT TO RQ 2

Both the proposal from the PCAOB and the proposal from the IAASB indicate a goal to provide readers of the auditor's report with enhanced information. The PCAOB states:

> *The proposed auditor reporting standard is intended to provide investors and other financial statement users with potentially valuable information that investors have expressed interest in receiving but have not had access to in the past* (PCAOB 2013, p. 6).

Similarly, the IAASB proposal is designed to benefit third parties:

> *The primary beneficiaries of the IAASB's work on auditor reporting will be investors, analysts and other users of the auditor's report* (KPMG, p.25).

In this section, we address the responsiveness of the proposed standards to specific information investors and other stakeholders want to be included in the audit report. We also evaluate whether the new information in the proposed standards is expected to close the "gaps" identified in Mock et al. (2013). Our evaluation is based on research cited in Mock et al. (2013) updated to include additional academic research since 2011. The evaluation is organized around the line items in Table 2 of the Mock et al. synthesis, which outlines a summary of findings and research opportunities. However, it is somewhat rearranged to correspond more closely to the requirements of the proposed standards.

Most importantly, the standard setters have proposed that the auditor's report should communicate more information about the audit and the auditee. The PCAOB is proposing that the auditor report on "critical audit matters" (CAMs) would be specific to each audit. The auditor's required communication would focus on those matters which the auditor addressed during the audit of the financial statements "that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements" (PCAOB 2013). Similarly, the IAASB is proposing that the auditor report on "key audit matters" (KAMs). These are matters that are of most significance in the audit and are to be selected among matters communicated with those charged with governance, and include: areas identified as significant risks, areas involving significant auditor judgment, and areas in which the auditor encountered significant difficulty during the audit, or required significant modification of the auditor's planned approach (IAASB 2013).

The proposed PCAOB standard also would enhance the auditor's responsibility with respect to "other information"[5] by adding audit procedures so that the auditor can evaluate the other information. The evaluation is intended to identify material misstatements of fact as well "as material inconsistencies with amounts or information, or the manner of their presentation, in the audited financial statements", and would be based on relevant evidence obtained and conclusions reached during the audit. The IAASB is also similarly revising the responsibility of auditors in relation to "other information" as part of a separate exposure draft on a proposed new ISA 720.

The PCAOB proposes adding information on auditor tenure that is not included in the IAASB standard. The PCAOB also proposes enhancing certain standardized language in the auditor's report such as the phrase "whether due to error or fraud" when describing the auditor's responsibility to obtain reasonable assurance, which is already in the IAASB standard; and the phrase "and the related notes" to the introduction paragraph to clarify that the notes are an integral part of

[5] "Other information" in the proposed other information standard refers to information in a company's annual report filed with the SEC under the Exchange Act that also contains that company's audited financial statements and the related auditor's report.

the financial statements. Both proposed standards have explicit requirements about auditor independence.

The IAASB standard includes a requirement for the name of the engagement partner to be disclosed and also requires reporting on going concern. Neither of these proposed changes is addressed by the PCAOB.

Information Gap Items Concerning the Financial Statements (Table 1, Panel A)

Table 1 summarizes our evaluation of whether the proposed standards address stakeholders' desires for specific entity (client) information to be included in the audit report. We also discuss whether such change should help close the information gap. The information gap line items in Table 1 Panel A are those in Panel A of Table 2 of Mock et al. (2013), somewhat rearranged so that they correspond to the requirements of the proposed standards.

Table 1 contains four columns, with Column (a) listing the possible information gap items. Columns (b) and (c) summarize the requirements contained in the PCAOB and IAASB EDs respectively and our belief as to whether the EDs will be responsive to stakeholder needs and will possibly help close the information gap, using a three-level scale (*Yes, Possibly, No*).

Column (d) indicates our assessment of the level of academic research that bears on the information item and to what extent significant research opportunities exist. We use a four-level scale (*Ample, Moderate, Minimal, None*) to signify the level of research on the information item, and a two-level scale (*Moderate, Significant*) to signify the extent of research opportunities. This column is discussed in the next section.

The proposed requirement for communication of "critical/key audit matters" (CAMs) could potentially and significantly respond to any of stakeholders' demands for financial statements information (Table 1, Panel A, Item 1) since the proposed standards require that the description of CAMs identify and describe the considerations, and refer to the relevant financial statement accounts and disclosures. This outcome assumes that the auditor would consider these items as CAMs in every audit. This assumption would hold for some entity information items, but not all. For example, the auditor would almost always view difficult or contentious issues as CAMs but may not view some of management's judgments and estimates as such.

One potential issue relates to what stakeholders may infer if an item they consider important is not explicitly discussed in a CAM communication. The most likely inference is that the auditor did not consider that particular item to be "critical," indirectly inferring the item was deemed "not critical."

More reporting on going concern (Table 1, Panel A, Item 2) is not addressed by the PCAOB exposure draft but is addressed by IAASB ED ISA 570 on Going Concern. This topic is on a separate PCAOB agenda. The auditor needs to conclude regarding the appropriateness of management's use of the going concern basis of accounting.

Research on the effect of going concern opinion suggests that unless "new" information is provided in the audit report, a going concern audit report does not appear to have significant information content.[6] Accordingly, given that the going

[6] As stated before, Menon and Williams (2010) and Kaplan and Williams (2013) document that going concern disclosures have value. However, they do not test whether a going concern audit report has incremental informational value over a financial statements disclosure.

concern information is already in the financial statement notes, the information about the going concern basis of accounting may not have information value. However, the auditor is making visible a conclusion about a specific assertion that is currently imbedded within the opinion on the financial statements. The users may then perceive that the auditor is giving a specific opinion on this assertion or think that the auditor is providing additional assurance. We are not aware of research on this issue.

The proposed standards generally do not address the third information gap items (Table 1, Panel A, Item 3). Non-GAAP information and MD&A are included in companies' annual reports; thus, they would be considered "other information" in the proposed other information standard. As such, auditors will be responsible to look for material misstatements of fact and material inconsistencies with information in the audited financial statements. This information, however, will not be audited. Thus, while the exposure draft will narrow the information gap in these areas, it does not respond to the users' demands for additional assurance related to these items.

Summary

The proposed standards will likely close the information gap for some financial statement items of interest to various stakeholders. The proposed PCAOB standards do not require any new procedures or information related to going concern, which is on a separate agenda. However, the IAASB proposed standard addresses this issue. The information gap on information other than financial statements is not generally addressed, and thus this issue will likely persist. The exceptions include non-GAAP information and information in the MD&A since the proposed auditor's responsibilities for these items likely will close the information gap.

Communication Gap Items Concerning the Audit (Table 1, Panel B)

Table 1, Panel B, columns (a), (b), and (c) list the "communication gap" items concerning the audit and the auditor, summarize the requirements of the PCAOB and IAASB proposed standards, and present our belief as to whether the requirements will be responsive to stakeholder needs and possibly close the "communication gap". Column (d) indicates our assessment of the level of academic research that bears on the information item and to what extent significant research opportunities exist. This column is discussed in the next Section.

The proposed standards do not address materiality (Item 1) and reasonable assurance (Item 4) given that other standards already address these matters to some degree. Implicitly, this seems to imply that the standard setters see these items as expectation gaps, and not communication gaps. Nomenclature aside, the evidence suggests that the proposed standard will not close these gaps.

A new element in the auditor's report requires a statement that the auditor is independent (Item 2) of the company in respect to the relevant laws or regulations (and ethical requirements for the IAASB). However, the reduction in information gap will be limited because users may lack knowledge of the requirements referenced, and the auditor may refer to multiple requirements. In addition, research studies show that users' perceptions of independence are affected by the level of non-audit services provided, the nature of these services, and the length of the auditor relationship with the company. Although the proposed PCAOB standard requires disclosure of audit tenure, and fees for non-audit services are disclosed in filing documents, the nature of non-audit services will remain unknown to users. Accordingly, the information gap may not be significantly reduced.

The proposed standards do not address the role of other auditors (Item 3) involved in the audit. Thus, unless the use of other auditors constitutes a CAM, which may be the case in some audits, the existing communication gap in this area remains.

The proposed PCAOB standard will likely close the gap related to auditor's responsibility for fraud (Item 5) by clarifying the auditor's responsibilities for fraud. These responsibilities may be somewhat clarified by adding the phrase, "whether due to error or fraud" to the auditor report. The current IAASB auditor reporting standard already has this statement included.

Both standards include an enhanced description of auditor's responsibility for financial statement disclosures (Item 6). This change may possibly reduce the communication gap. However, both the PCAOB and IAASB decided that no changes were needed to the discussion on management's responsibility (Item 7) for the preparation of financial statements.

As noted earlier, in relation to information outside the financial statements (Item 8), communications such as Non-GAAP information and MD&A are included in companies' annual reports, and thus would be considered "other information" in proposed standards relating to auditor reporting on other information. Issues related to significant audit risks (Items 9-10), such as issues of significance related to the audit scope or strategy, difficult or contentious matters, and audit procedures responsive to these risks, will likely be addressed as CAMs. Each CAM should identify a specific issue that arose during the audit and provide disclosures related to the relevant financial statement accounts.

The disclosure of the audit partner’s name (Item 11) is required in the IAASB standard, but not the PCAOB standard. For the IAASB, this responds to stakeholder demand for the partner’s name and some recent research that suggests it will increase audit quality.

A proposed change that was not part of the synthesis table in the Mock et al. (2013) study relates to auditor tenure. The PCAOB standard adds a new element to the audit report to provide information on auditor tenure. Although this information has been available through the SEC filings, its appearance on the audit report might help close the communication gap. This is not proposed by the IAASB.

Summary

In summary, the proposed standards will likely close the communication gap relative to many audit and auditor items of interest to various stakeholders. The proposed standards do not require new procedures or disclosures related to the role of other auditors, materiality, or level of assurance. Thus, the communication gap relating to these items will remain.

FINDINGS WITH RESPECT TO THE RESEARCH GAP (RQ 3)

Because topics related to the auditor’s report are critical to the financial markets, we analyze the level of research evidence available related to the auditor’s report. Tables 1 and 2, column (d), summarize our evaluation of to what extent a “research evidence gap” exists. We indicate the level of evidence from reviewed research supporting our conclusion on a four-level scale (Ample, Moderate, Minimal, None) and the extent of research opportunities on a two-level scale (Moderate, Significant). The research reviewed includes approximately 120 academic research studies beginning in 2007.

Information Gap Items Concerning the Financial Statements Table 1, Panel A

Financial Statements, Item 1

As Table 1, Panel A indicates, there is either minimal or no prior research on most of the listed items that may be communicated in the auditor's statement concerning CAMs. The onus will be on auditors to select which CAMs to include. The newness of these disclosures creates significant research opportunities. For example, researchers could investigate the frequency of items that are included in CAMs or to assess which included items affect the users' decisions. Also, the variability of disclosure will create opportunities for researchers to examine the decision making process of auditors in this task and the impact on various audit variables such as litigation risk, audit delay, audit costs, and financial statements quality. Researchers could also examine the benefits of having the auditor provide this information rather than management or the audit committee as done in the U.K.

Finally, researchers could examine the potential impact of this requirement on the nature and candidness of communications between the audit committee (and management) and the auditor, and thus the quality of audit. For example, experimental research using eye-tracking technology could trace users' reactions to and use of the extended information compared to cases that communicate the traditional pass/fail feature of the report.

Going Concern, Item 2

Given that the PCAOB proposal does not reference going concern, research opportunities relate mostly to the IAASB proposal. However, given that the auditor's CAMs for audit using PCAOB standards may include factors related to the going concern assumption, there exists significant opportunities to conduct studies to determine 1) which going concern items are included in the CAMs, 2) which items might be confusing or misleading, 3) which items affect the users' decisions, and 4) in what form the information is disclosed. Research is clearly needed to ascertain what set of items will be investigated/considered by the auditor and whether the inference of factors not being communicated are indeed "not critical" factors.

Research has not identified the effect of the IAASB proposal on the going concern assumption where there are no significant issues identified by the auditor. This type of communication is essentially negative assurance. Thus, in addition to research into the effects of positive assurance on going concern, there will be significant opportunities for research into the effects of negative assurance.

Information Gap Items Concerning Other Information, Item 3

There has been some research on many of the listed "other information" items. The main gaps in research involve the limited research on assurance of non-financial information disclosure and also assurance of company earnings releases. We do not provide detailed discussion in this review because the proposed standards are focusing on reporting more information about the current audit process rather than expand the auditor's responsibilities into some of these areas.

Communication Gap Items Concerning the Audit (Table 1, Panel B)

Materiality, Item 1

We are not aware of any study that examines the effect of additional disclosures by auditors on materiality and methods of determining its level. There are significant opportunities to identify the effects of materiality disclosures on users' decisions.

Auditor Independence, Item 2

Significant archival research has examined auditor independence, although users' perceptions of factors associated with auditor independence has received little attention. There is no research about the effect of the value of information disclosure on independence on users' perceptions and decisions, as proposed in the new standards.

Items 3 - 8

Although being addressed elsewhere, the role of other auditors in complex, multi-country audits presents significant research opportunities. Other proposed communications include: disclosure of the identities and roles of other auditors, disclosure of the level of assurance, and potential changes in the auditor's responsibilities for detecting fraud. Experiments, surveys, and protocol analyses could help identify changes that would potentially affect users' decisions, or improve the communicative value of the audit report or the quality of the audit.

Items 9 - 10

Users request additional communications concerning significant audit risks and information related to the audit scope or strategy. These will potentially be disclosed in the new CAMs. Significant research opportunities exist is all of these areas. For example, experiments, surveys, or protocol studies can examine whether the disclosure of audit procedures designed to address identified risks affect and more importantly improve users' decisions and audit quality.

Audit Partner Name, Item 11

Archival and experimental studies examining the impact of audit partner signatures on audit quality offer mixed results. However, a recent study conducted in the UK where partner names are reported by Carcello and Li (2013) finds this requirement is related to improved audit quality, but also to increased fees. Future research should address the research limitations identified in Blay et al. (2011), such as obtaining direct evidence on the effect of the signature on user decisions or judgments, and exploring other potential benefits of a mandatory partner-level signature requirement. It can also address the question of whether the benefits exceed the costs and effects on audit quality.

Conclusion Concerning the Research Evidence Gap

The general question we address in this paper is does academic research provide sufficient, competent evidence concerning possible changes to the audit reporting model? Clearly, Column (d) of the Table 1 documents important gaps in research evidence upon which to either assess the responsiveness of the proposed standards to the information and communication gaps or the likelihood of the gaps being reduced. In some cases the research outcome is mixed, but many items have essentially no prior research that is directly relevant. Given that most of the research evidence is at best moderate, it is difficult for standard setters and regulators to base their standards on sufficient research results.

Several factors may explain this lack of evidence published in academic journals. The most critical seems to be insufficient access to evidence collected by audit firms themselves or by external inspection and quality control activities. Also, researchers face significant challenges in accessing appropriate participants in experimental, survey, interview, and process-tracing studies, which could generate useful research evidence.

If one uses the publication process to filter out the most useful research, then another factor relates to timing as the time span from genesis of an academic research project to publication is usually quite lengthy. Also, some of the items being considered by the PCAOB and IAASB proposals are relatively new. While researchers may be studying them, the results of these studies may be in pre-publication form. As noted above, we have considered only a few such working paper studies. This research evidence “gap” suggests the need for the PCAOB and the IAASB to more closely work with the auditing research community and to provide or facilitate increased support to auditing researchers. Such support will help provide research relevant to standard deliberations, including facilitating the study of the impact of both proposed and implemented standards.

Conclusion

The PCAOB and the IAASB have issued proposals that will fundamentally change the auditor's report and disclosures to the public. Because such changes could have a profound impact on financial statement users and the capital markets, we analyze relevant research related to proposed requirements in the exposure drafts issued by the PCAOB and IAASB. We build on the synthesis performed by Mock et al. (2013) by analyzing approximately 40 additional academic papers. The results of this paper should interest standard setters by providing relevant analysis related to the proposed standards. Furthermore, our paper should help academics see the research evidence gaps in the literature, thereby showing avenues of future research and hopefully encouraging researchers to investigate these topics.

Though the motivation of our analysis is to focus on the current IAASB and PCAOB exposure drafts, the results of our paper should remain relevant for the foreseeable future for a variety of reasons. First, the standard setting process is a long, slow, deliberative, and often controversial process. Thus, regardless of the standards ultimately enacted by the IAASB and PCAOB, questions and proposals regarding the auditor's report will likely persist for years to come. Second, there are multiple standard setting bodies including the PCAOB, ASB, and IAASB and the differences in standards among these groups related to the auditor's reporting model will likely continue to foster questions about the issues we analyze. Finally, even if the standard setting bodies enact rules in areas where limited academic research exists, researchers will likely conduct research into these areas *post hoc*. We call on researchers and standard setters to work together more closely to investigate ways to improve the auditor’s report.

Table 1: An analysis of how the PCAOB and IAASB Exposure Drafts respond to the information and communication gaps

Panel A, Information Gap Items Related to the Entity

(a) **Information Gap Items**	**(b)** PCAOB proposal and degree of responsiveness to stakeholders demands **(Yes, Possibly, No)**	**(c)** IAASB proposal and degree of responsiveness to stakeholders demands **(Yes, Possibly, No)**	**(d)** **Findings concerning possible research evidence gap** Level of evidence from prior research **(Ample, Moderate, Minimal, None)** and research evidence gap opportunities **(Moderate, Significant)**
1. Financial Statements:			
• Accounting policies and practices • Management's judgments and estimates • Difficult or contentious issues, including "close calls." • Material Matters • Component of a larger business enterprise. • Significant transactions with related parties • Unusually important subsequent events • Accounting matters affecting the comparability of the financial statements • Most significant matters in the financial statements	Disclosure of Critical Audit Matters (CAMs) **Yes.** These items may be included in the CAMs reported in the audit report (par. 10)	Disclosure of Key Audit Matters (KAMs) **Yes.** These items may be included in the KAMs reported in the audit report (par. 30)	**Minimal.** A couple of recent studies have explored the use of CAMs. **Significant opportunities**. For example, studies to determine the frequency of items which are included in the CAM and which included items affect the users' decisions. Also, the variability of CAM disclosures will create opportunities for researchers to examine the decision making process of auditors and their impacts on various variables such as litigation risk.

2. Going concern	Will be addressed as a separate agenda item. **No**	Auditor's conclusions related to management's use of going concern. **Possibly.** Stakeholders' demands appear to be more for improved early warning for bankrupt companies, than improved communication in the audit report. Thus, unless increased disclosure in the audit report change the auditor behaviour, the IASB proposal might not respond to users' needs.	**Ample.** Prior research on some aspects – earlier archival studies question the value of the auditor's going-concern opinion while later papers found such opinions useful to the market. Recent research provides more evidence that financial statement users find the auditor's going-concern opinion useful. **Significant opportunities.** In some areas, for example, the value of positive assurance on the going concern assumption when there are no identified problems, or the impact of explicit auditor's assessment of the appropriateness of management's use of the going concern assumption on auditor behavior.
3. Other Information:			
• Management forecasts • Quarterly financial statements • Non-GAAP information • Earnings releases • Internal controls over financial reporting • Key performance indicators • Corporate governance arrangements • Sustainability information • MD&A	The PCAOB exposure draft has restricted the communication only to matters about the audit, i.e., CAMs	The IAASB exposure draft has restricted the communication only to matters about the audit, i.e., KAMs	**Moderate.** Although it is varied in extent across these items, overall there is a reasonable amount of research evidence on the disclosure of these items. **Significant opportunities** for more research on these topics, particularly behavioral research as many of these items are not currently audited in practice.

Table 1: An analysis of how the PCAOB and IAASB Exposure Drafts respond to the information and communication gaps (continued)

Panel B Communication Gap Items: Audit

(a) **Communication Gap Items**	(b) PCAOB proposal and degree of responsiveness to stakeholders demands **(Yes, Possibly, No)**	(c) IAASB proposal and degree of responsiveness to stakeholders demands **(Yes, Possibly, No)**	(d) **Findings concerning possible research evidence gap** Level of evidence from prior research **(Ample, Moderate, Minimal, None)** and research evidence gap opportunities **(Moderate, Significant)**
1. Materiality	The PCAOB exposure draft does not explicitly consider this. However, the disclosure of CAMs could provide information on this.	The IAASB exposure draft does not explicitly consider this. However, the disclosure of KAMs could provide information on this.	**None.** No published academic study directly relevant to this topic. **Significant Opportunities** exist to identify effects on users' decisions.
2. Auditor independence	Explicit requirement that audit firm be independent with respect to the client in accordance with federal securities laws and the rules and regulations of the SEC and the PCAOB **Possibly.** The disclosure will partially respond to the demand, since research show that users care about other independences issues such as non-audit services and audit firm tenure.	A statement that the auditor is independent of the entity within the meaning of the relevant ethical requirements or applicable law or regulation and has fulfilled the auditor's other responsibilities under those requirements. **Possibly.** The disclosure will partially respond to the demand, since research show that users care about other independences issues such as non-audit services and audit firm tenure.	**Moderate.** Research shows that users react to information about some independence issue such as the level of non-audit services, but there is no research on the value of information about the independence requirement followed by the auditors. **Significant opportunities**, for example to identify the effect of these changes on users' decisions.
3. Role of other auditors involved in the audit	The PCAOB exposure draft does not explicitly consider this.	The IAASB exposure draft does not explicitly consider this.	**Minimal** prior research **Significant opportunities** exist to expand this line of research to the use of other auditors
4. Reasonable assurance	The PCAOB exposure draft does not explicitly consider this.	The IAASB exposure draft does not explicitly consider this.	**Moderate** level of prior research with mixed results. **Significant opportunities**, for example to identify effects on users' decisions.
5. Auditor's responsibility for fraud	Enhancements related to the auditor's responsibilities for fraud by adding the phrase, "whether due to error or fraud" **Yes**. Statement as to responsibility explicitly required.	The IAASB exposure draft does not explicitly consider this. However, the current IAASB auditor's report already includes an equivalent discussion on fraud.	

6. Auditor's responsibility for financial statement disclosures	An enhanced description of the auditor's responsibilities is required **Possibly**. The required enhanced descriptions may reduce the information gap.	An enhanced description of the auditor's responsibilities is required **Possibly**. The required enhanced descriptions may reduce the information gap.	**None.** No published academic study directly relevant to this topic **Significant opportunities** for research on this issue.
7. Management's responsibility for the preparation of the financial statements	No change to current disclosures	No change to current disclosures.	**None.** No published academic study directly relevant to this topic. **Significant opportunities** for research on this issue.
8. Auditor's responsibility for information outside the financial statements	There is a proposed standard on communication of the auditor's responsibilities with respect to information in documents containing or accompanying the financial statements and of whether the auditor has identified material inconsistencies in the other information.	There is a proposed standard on communication of the auditor's responsibilities with respect to information in documents containing or accompanying the financial statements and of whether the auditor has identified material inconsistencies in the other information (ISA 720). This is not part of the ED related to the audit reporting model.	**Moderate.** Research shows a need for information, but there is no information as to whether communications of the auditor's responsibilities affects users' perceptions. **Significant opportunities** for research on this issue.
9. Significant audit risk, audit procedures responsive to theses risk, and results of these procedures 10. Significant risks, issues of significance related to the audit scope or strategy, difficult or contentious matters noted during the audit	Disclosure of CAMs **Yes.** These items are included in the CAMs reported in the audit report	Disclosure of KAMs **Yes.** These items are included in the KAMs reported in the audit report	**Minimal.** Only a couple of recent published studies on K/CAMs. **Significant opportunities** for research on this issue.
11. Audit partner name	Item not addressed in the proposed standard. **No.**	Required disclosure of partner's name for listed clients. **Yes.** For public companies, the requirement will respond to stakeholder demand for partner name. In addition, research results suggest that such disclosure seems to improve audit quality.	**Minimal.** Research has examined the effect of mandatory disclosure of partner name in the United Kingdom. **Significant opportunities** for more archival research on the effects of these disclosures.

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Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience

Jean Bédard
Université Laval
Chair in Corporate Governance
Jean.Bedard@ctb.ulaval.ca

Nathalie Gonthier-Besacier
University of Grenoble
CERAG, UMR CNRS
nathalie.gonthier@iae-grenoble.fr

Alain Schatt
HEC Lausanne (UNIL)
Chair in Financial Accounting
Alain.Schatt@unil.ch

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Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience

Abstract

This article presents original results on the effects of the justification of assessments (JOA), which are mandatory in France since 2003. These JOA are similar to Key Audit Matters that might be disclosed by auditors around the world in a near future, in order to enhance the informative value of auditors' reports. Our results show that the disclosure of additional information by French auditors has very limited effects. On the one hand, the financial market does not react significantly to these JOA. On the other hand, the quality of the audit (proxied by a measure of earnings management), the cost of the audit (proxied by audit fees) and the efficiency of the audit (proxied by the audit report lag) are not significantly affected by the JOA. Finally, our results confirm the idea that the disclosure of additional information by the auditors rather has a symbolic value than an informative value. However, it is likely that our results might be different in other institutional contexts, especially in contexts where the auditors' liability is not similar, or in contexts where auditors not only disclose clean opinions. Thus, our results allow enriching the current international debate on the introduction of Key Audit Matters.

Keywords

Key audit matters - France - Market reaction - Audit quality - Audit lag - Audit fees.

Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience

INTRODUCTION

The International Auditing and Assurance Standards Board (IAASB 2013) and the Public Company Accounting Oversight Board (PCAOB 2013) have recently proposed for public comment new auditing standards that would require auditors to communicate in the audit report "Key Audit Matters" (KAM) specific to the audit. These changes in audit reporting aimed at reducing the information gap – differences between the information users desire and what is available to them through the entity's disclosures and the auditor's report (IAASB 2011).

There is no evidence yet on whether a requirement for auditors to communicate additional information will increase the communicative value of the audit report and reduce the information asymmetry that exists between company management and investors. Indeed, there are concerns about these communications. Over time, they may become boilerplate (IAASB 2012a; Footprint Consultants 2011), liability concerns may results in auditors reporting on as few matters as possible or providing a lengthy list of redundant disclosures (IAASB 2012a), the disclosures may not be easily understandable because of the use of technical language (Footprint Consultants 2011), they may result in excessive other reporting that might cause the auditor's report to be ambiguous (IAASB 2011), and in additional cost with questionable benefit (IAASB 2012a).

The idea of auditor disclosure of key audit matters is not completely new. In France, since 2003, auditors must provide commentaries, called "Justification of Assessments" (JOA), in their report. JOA are very similar to key audit matters in that they must "enable the user of the report to obtain a better understanding of the reasons behind the statutory auditors' opinion on the financial statements" (Haut Conseil des Commissaires aux Comptes 2006). As for the key audit matters they are disclosed in separate section after the audit report and when applicable, refer to the relevant financial statement accounts and disclosures that relate to the disclosed matter.

This study aims to assess some of the benefits and costs of such JOA. In order to do so, we create a database of 953 annual reports of large French listed companies, for the period 2000-2011. In a first step, we study the reaction of the French financial market at the announcement of the JOAs. Our results show that the market reaction is not more different since the disclosure of the JOAs. Therefore, we conclude that the information content of such reports is low for investors.

In a second step, to better understand the reaction of the financial market, we focus on three aspects of the audit: its quality, its cost and its efficiency. First, the quality of the audit, which is proxied by a measure of earnings management, is not affected by the introduction of the JOA in France. In other words, it seems that the auditor does not provide additional efforts other than those of writing one or two additional pages. Second, the cost of the audit, proxied by audit fees, is not signicantly modified by the JOA. Therefore, the quality/cost ratio of audit services is not really modified by the introduction of JOA in France. Third, the efficiency of the audit, proxied by the audit report lag, is however slightly affected by the introduction of the JOA. Overall, these results on the three dimensions of the audit (quality, efficiency and cost) help to understand the absence of a reaction of the French financial market to the JOAs.

These results contribute to enrich the academic literature. We confirm that additional disclosures by auditors have no informative content (no reaction of the financial market) and do not affect the key characteristics of the audit (quality, efficiency, cost). Therefore, we confirm that the content of an audit report, even more detailed, remains essentially symbolic (Church et al. 2008; Mock et al. 2013). Besides, our results allow enriching the current international debates on the introduction of KAM. Because we find that more detailed audit reports are of limited value in France, we consider that it is likely that the effect of the introduction of KAM will be extremely limited in similar countries. However, it is possible that in other institutional contexts the introduction of KAM may have more pronounced effects. Il is notably the case in countries where minority shareholders have stronger rights to sue auditors, or in countries where auditors do not systematically issue clean opinions. Therefore, it may be appropriate to adjust the new constraints (KAM disclosures) based on the institutional context.

The remainder of this paper is organized as follows. In a second section, we present the institutional contexts relating to the establishment of KAM disclosure, and of JOA in France. In the third section, we discuss the costs and benefits that can be expected from the introduction of the JOA in France. The fourth section is devoted to our methodology. The fifth section presents and discusses our results. A final section summarizes our results and concludes.

INSTITUTIONNAL CONTEXT

The idea that auditors should disclose more detailed reports spreads widely since the 2008 financial crisis. The IAASB, the PCAOB and the European Commission are particularly favorable to the disclosure of Key Audit Matters (or Critical Audit Matters) by auditors. A few years ago, such a debate existed in France, where auditors are required to justify their assessments since 2003.

The proposal of introduction of Key Audit Matters (KAM)

Following the recent financial crisis, many economic and political actors around the world have questioned the role of auditors. In particular, they criticize the fact that the audit report is highly standardized and its information content is low. For example, in the invitation to comment, Professor Arnold Schilder states in his IAASB chairman's statement:

"What does today's auditor's report on financial statements deliver? It is generally a short, standardized report that describes the financial statements subject to audit, the audit itself, and the respective responsibilities of management and the auditor. (-) The global financial crisis also has spurred users, in particular institutional investors and financial analysts, to want to know more about individual audits and to gain further insights into the audited entity and its financial statements. And while the auditor's opinion is valued, many perceive that the auditor's report could be more informative. Change, therefore, is essential".

To have a clear idea about the fundamental changes in the audit reports that should be implemented, the IAASB launched consultation papers in May 2011 and June 2012, that were followed, on July 2013, by an exposure draft "*Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing* (the proposed ISAs)".[1] The

[1] The timetable is the following: Comments are requested by November 22, 2013; The approval of final revised auditing standards is June 2014; The proposed effective date is December 2016.

objective is to increase the communicative value of auditor's report to users. To achieve this objective, the proposed ISAs require, among other, that auditors of financial statements of listed entities communicate in a separate section of their report Key Audit Matters (KAM).

KAMs are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. KAM are selected from matters communicated with those charged with governance. In determining which of the matters communicated to those charged with governance are KAM, the auditor should take into account areas of significant auditor attention in performing the audit, including: (a) Areas identified as significant risks or involving significant auditor judgment; (b) Areas in which the auditor encountered significant difficulty during the audit, including with respect to obtaining sufficient appropriate audit evidence; (c) Circumstances that required significant modification of the auditor's planned approach to the audit, including as a result of the identification of a significant deficiency in internal control.

A quick look at the responses to this ED highlights that the community of users of financial statements (financial analysts and investors) are generally satisfied by this proposal. For example, the CFA Institute[2] argues that: "*Through increased transparency, a revised standard auditor's report (SAR) will facilitate better analysis and heighten user confidence in the audited financial statements"*. Besides, this Institute indicates the results on a survey, which highlights that: (a) Fifty-eight percent of respondents indicated that the auditor's report needs to provide more specific information about how the auditor reaches their opinion; (b) Seventy-five percent of respondents believe that risk factors associated with measurement uncertainties in an entity's financial statements should be included in the independent auditor's report. However, the CFA Institute is concerned by the content of the new report: "*Our principal concern is that the language used in the proposals prescribes a more subjective approach - what the auditor determines "key" or "critical" to be - rather than a more objective approach. The proposed subjective approach might easily allow an artful avoidance of providing any additional information whatsoever to investors*". Besides, it recalls that: "*In our previous letters, (-) our request was to have the auditor report the most relevant of these same matters, whether we refer to them as key or critical, in plain, non-boilerplate language. With this*

[2] The CFA Institute "is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide". This Institute "seeks to promote fair and transparent global capital markets and to advocate for investor protections".

approach there would not be an increase in audit scope or additional procedures, rather the auditor would simply report what was done in the audit, using information already contained in the audit completion memo".

In its response to the PCAOB proposal, the Council of Institutional Investors - CII[3] (8 January 2014), also agrees with the disclosure of CAMs, but suggest a minor adjustment: "*However, we would revise the proposed model to provide that the auditor is required to communicate, at a minimum, an assessment of management's critical accounting judgments and estimates based on the audit procedures the auditor performed*."

French "Justification of Assessment" (JOA)

A decade ago, similar proposals on disclosure of KAM by the auditors have been raised in France. Following the financial scandals of the new millennium, the French government adopted Financial Security Act (Assemblée Nationale française 2003), which among other require the auditors to justify their assessments (JOA) in order to help the users of the audit report to have a better understanding of the opinion provided by the auditor. More specifically, the French Code of Commerce states that the auditor justifies in its report the findings made during the audit (Article L. 823-9). This requirement has been in force from 2003 and then the subject of a specific professional standard "NEP 705: Justification of assessments" (Haut Conseil des Commissaires aux Comptes 2006), which basically explains how to implement the JOAs.

Five key points are emphasized in the standards: (a) the "justification of assessments" (JOA) carried out by the auditor helps to explain the auditor's opinion; (b) the JOAs must allow the user of the report to better understand the reasons for which the auditor has issued his opinion on the financial statements; (c) the clarification of certain assessments cannot replace the need to make a qualified opinion or a disclaimer of opinion; (d) on the basis of professional judgment and in view of the steps taken throughout its mission, the auditor decides what justifications are important; (e) the JOAs generally relate to important matters for the understanding of the financial statements. These important matters are: options used in the selection of accounting policies or in their implementation, critical accounting estimates

[3] CII is "a nonprofit organization of corporate, union, public and pension funds, foundations, and endowments, with combined assets That Exceed $ 3 trillion Member funds are major shareowners. Generally with a duty to protect the retirement assets of millions of American workers".

(including those involving professional judgment in their assessment), and the overall presentation of the annual and consolidated accounts.

In addition, the standards indicates that the formulation of the JOA:

1) must be clear and include for each assessment: (a) identification of the subject and reference to the notes; (b) a summary of the diligence taken by the auditor to base its assessment; (c) a conclusion, expressed positively, consistent with the opinion expressed on the financial statements.
2) should not provide specific insurance on isolated elements of the accounts subject to a JOA by the auditor .
3) appears in a separate part of the report, that can be found after the expression of the auditor's opinion.

To date, according to Gélard (2012), the French representative at the IAASB, France is the only country "*where an audit report with a non-standard part is disclosed, in which the auditor reports the work he conducted on the most sensitive points of the audit*". Thus, France "*was a laboratory since it has created a solution that makes the audit report more informative and aims to respond to users' criticisms about its completely standardized character*".

To our knowledge, no research study has examined the benefits and costs of the JOAs in France. One study conducted by consultants for the French institute of auditors (CNCC) examined users' perception of JOAs through interviews 34 persons (Footprint Consultants 2011). This study shows that JOAs are generally well perceived by users. They appreciate the flagging of areas of importance and take a closer look at the items referred to in the justification. We extend this study by examining the benefits and costs of JOAs, using archival data.

EXPECTED BENEFITS AND COSTS OF JOAs

The expected benefits and costs of JOAs must be considered along with its dual nature. On the one hand JOA may be viewed as a pure supplementary information in the audit report. This conception leads to appreciate its benefits through its informative content which can namely been measured by empirical studies based on market reactions (Holt and Moizer 1990). On another hand, this paragraph can be viewed as a new procedure imposed to auditors. This latter conception leads to appreciate its benefits and costs in terms of audit quality, cost or/and efficiency.

Market reaction to JOAs

There are two competing views about the economic consequences of the JOAs. The first approach considers that the information asymmetry is reduced between auditors and users of annual reports when JOAs are disclosed. In this case, JOAs could be an appropriate solution to the information needs of users. Insofar as the JOAs can provide new information to users of annual reports, we may find that the financial market reacts to their disclosure.

The second approach considers this type of disclosure as symbolic; it does not modify the behavior of investors and auditors. Academic research on the content of audit reports generally shows that the information content of audit reports is very low. Church et al. (2008) conclude that the audit report is mainly symbolic. This may even to be the case when the auditors issue a going-concern opinion, because investors permanently revise their expectations and do not wait for the auditor report. In this context, the reaction of the financial market does not depend on the content of the audit report, even if this report is more detailed. In other words, it is likely that the JOA have no informative value. This is especially the case when the detailed audit report is too standardized ("boilerplate"), or too complex (in terms of readibility), or too heavy to digest (due to cognitive overload).

JOA and audit quality

JOA could results in better quality audit. Disclosing that some key elements were analyzed may make auditors feel more accountable for matters to be reported, leading them to make additional efforts to analyze these elements. Some investors believe in such a positive effect. For example, in its response to the ED of the IAASB, CII (2014) argues that we could anticipate "*quality competition among audit firms, particularly in the area of professional skepticism*, [which] *enhance the value of the audit to investors*." Moreover, these key elements are more visible to users, which may increase the costs to the auditor if problems occur with these elements subsequently. However, such a phenomenon is less likely in France, where a minor investors' protection lowers the probability that auditors may pay significant penalties for material misstatements, whether caused by fraud or error.

JOAs and audit fees

JOA may results in additional audit costs because of increased audit efforts as well as reporting costs. Auditors may increase their procedures to respond to the higher liability and reputation risk associated with JOAs, and develop quality control processes as well as the discussions of the form and content with senior management and the audit committee, which are incurred by the most senior members of the engagement team (IAASB, 2012b).

Nevertheless, the JOAs requirements should not represent a significant departure from other audit requirements. Moreover, it is likely that most of those costs might be recurring since auditors may standardize their reporting within their audit firms, which reduces costs. In addition, for a given clients, if the same issue shows up in the next year, the reporting costs should be much lower. Overall, stakeholders seem to believe that there will be no additional material costs associated with KAMs. For example, the PCAOB (2013) "*does not anticipate significant additional costs".* This view is shared by the CFA Institute, which, in its reply to the ED of the IAASB, says "*We do not believe that there would be additional material costs for communicating critical audit matters*".

JOA and audit report lag

JOA may affect the efficiency of the audit the audit. In particular, the audit report lag could be extended. In fact, the "*effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit*" (PCAOB 2013). Auditors' response to this additional work may be to reduce the effort on other elements (review and completion of the audit work), add more resources, or surely delay the issuance of the audit report. In addition, discussion of the form and content of JOAs with management and audit committees prior to issuing the auditor's report may also delay the issuance of the auditor report. Indeed, the IAASB (2012b) indicates that the more iterative process to finalize the auditor's report may affect the timing of release of the financial statements and the auditor's report.

SAMPLE SELECTION AND EMPIRICAL MODELS

Sample

Our sample covers the years 2000-2011. This period includes the first year of application of JOAs in France (2003) and allows thus some pre/post comparisons. To create our sample, we start with the list of companies composing the SBF 120 index, which is based on the 120 largest market capitalizations in Euronext Paris, in December 2011. We exclude non-French companies because their auditors are not subjected to the JOAs requirement and companies in the financial services sector. We require firm-year observations to have the annual financial statements available on the French market authority (Autorité des Marché Financiers) or another WEB source. In addition we require firm-year observations to have the necessary financial data on the Wordscope database. We also require valid returns data from the Datastream database, non-missing audit fee data from the annual report (for the audit fee model) as well as the filing date on the French market authority WEB site (for the audit delay model) . These procedures leave us with 815 firm-year observations (101 unique firms) for the market reaction model, 462 firm-year observations (101 unique firms) for the audit quality test, 721 firm-year observations (96 unique firms) for the audit fee model, and 953 firm-year observations (103 unique firms) for the audit delay analysis. Different samples were thus built for each of our four empirical models. In order to clarify their presentation, descriptive statistics are provided in each correspondent Table and not globally.

Empirical Models

We test four different models to understand what the introduction of the JOA changed in France: a model to assess its information content (market reaction) and three models to assess three key features of the audit: its quality (proxied by a measure of earnings management), its cost (measured by audit fees) and its efficiency (measured by audit report delay).

We use five tests variables. First, *JOA*, an indicator variable equals to one if the company's auditor report includes justification of assessments, and zero otherwise. *JOA* allows us to test the effect of the JOA requirement. To examine whether the effect is larger in the first year of the requirement, we use *JOA_FIRST*, an indicator variable equal to one for the first year the company's auditor report includes justification of assessments, and zero otherwise. To examine the effect of the number of matters, we use *NB_JUSTIF*, the total number of matters mentioned in the justification of assessments section of the audit report. To examine the effect of new matters mentioned after the first year, we use *%NEW_JUSTI*, the percentage of new matters in the JOA section of the current year (number of new matters / total number of matters). Finally, we examine the effect of the readability of the justifications paragraphs using *SCOLARIUS*[4], a measure of readability developed for French texts (the higher the score, the more difficult the text to read).

[4] Scolarius was developed by Influence Communication for French texts and is inspired by the Flesh Formula, Fog Index, Fry readability Score, and Easy Listening Formula. More information on the index is available at http://www.scolarius.com.

We use firm fixed effect models to test the effect of JOAs. By including companies as fixed effect, these models control for all time-invariant unobserved variables, just as if they had been included in the model. As a consequence, we cannot include variables that do not change over time such as industry and number of subsidiaries. The effect of these variables being included the firm fixed effects.

Model 1: Market reaction analysis

The first model allows us to examine the reaction of the financial market when JOAs are disclosed. More precisely, we conduct an event study to measure the cumulative abnormal returns (*CAR*) around the announcement date.[5]|

$$
\begin{aligned}
|CAR| = \ & \beta_0 + \beta_1\, JOA + \beta_2\, JOA\_FIRST + \beta_3\, NB\_JUSTIF + \beta_4\ \%NEW\_\ JUSTI + \\
& \beta_5\ SCOLARIUS + \beta_6\, LN\_MARKET\_CAP + \beta_7\, FILING\ DELAY + \beta_8\, MB \\
& + \beta_9\, DEBT + \beta_{10}\, VAR\_NI\_TA + \beta_{11}\, ROA + \beta_{12}\, IFRS + \beta_{13}\, CROSS\_LIST + \\
& \textit{firm fixed effects} + \textit{year fixed effects} + \varepsilon \qquad (1)
\end{aligned}
$$

We use the absolute value of cumulative abnormal returns (|*CAR*|) over the filing and the following day. If the JOAs reduce the information asymmetry, the coefficient on *JOA* will be positive. That effect should be stronger for the first year JOAs are disclosed than in subsequent years where that information is repeated. We thus expect the coefficient on *JOA_FIRST* to be positive. Because more matters provide more information about the audit, and accordingly do reduce more intensively the information asymmetry, we expect a positive coefficient on *NB_JUSTI*. As for *JOA_FIRST* we expect that when new matters are disclosed, the market reaction will be higher. We then expect the coefficient on *%NEW_JUSTI* to be positive. Finally, less readable JOAs audit report sections make it more difficult for investors to understand the information provided in the JOAs. We then expect a negative coefficient on *SCOLARIUS*.

We control for firm size (*LN_MARKET_CAP*), delay in filing the annual report (*FILING_DELAY*), market-to-book ratio (*MB*), leverage (*DEBT*), variation in net income

[5] If such an analysis may be really useful, we also agree that an event study has two main limitations. First, it appears that the audit report in included in the annual report, which means that it is extremely difficult to isolate the informative value of the audit report. Second, to assess the information content of the audit report, it is necessary that the financial market has no access to this information prior to the date of announcement. For a researcher, it is very difficult to control what is already expected by the market.

(*VAR_NI_TA*), return on assets (*ROA*), whether the firm use the IFRS (*IFRS*), whether the firm is cross-listed in the U.S. (*CROSS_LIST*), as well as for firm and year fixed effects. The Appendix summarizes each variable's definition.

Model 2: Audit quality analysis

Our second model allows us to assess the impact of the JOAs disclosure on audit quality. Following previous research we use unexpected accruals as a measure of audit quality. We estimate the following model to examine the relation between audit quality and the JOAs.

$$
\begin{aligned}
|\mathrm{UNACC}| = \; & \alpha_0 + \alpha_1\, JOA + \alpha_2\, NB\_JUSTIF + \alpha_3\, \%NEW\_JUSTI + \alpha_4\, LOGASSETS \\
& + \alpha_5\, DEBT + \alpha_6\, ROA + \alpha_7\, LOSS + \alpha_8\, CROSS\_LIST + \alpha_9\, TWOBIG4 + \\
& \alpha_{10}\, ONEBIG4 + \text{firm fixed effects} + \text{year fixed effects} + \varepsilon \qquad (2)
\end{aligned}
$$

We use the absolute value of unexpected accruals (|*UNACC*|). These accruals are generated by the modified Jones (1991) approach (Dechow et al. 1995). If the JOA have an effect on audit quality, then we expect JOAs to be negatively associated with |*UNACC*|. To test this model, we use three variables of interest: *JOA*, *NB_JUSTI* and *%NEW_JUSTI*. Following prior research (Becker et al. 1998; Frankel et al. 2002; Ashbaugh et al. 2003)), we also control for firm size (*LOGASSETS*), leverage (*DEBT*), profitability (*ROA* and *LOSS*), and whether the auditors dyad is composed of two Big 4 auditors (*TWO_BIG4*) or one Big 4 and a non-Big 4 (*ONE_BIG4*). These two last variables allow to assess the quality of auditors in France, where companies are forced to use two auditors (Francis et al. 2009).

Model 3: Audit Fee Analysis

We assess the impact of JOA on the audit fees using the following model, that we estimate for the period for which this information is available (2003-2008; audit fees were not published in France before 2003).

$$
\begin{aligned}
LOGAUDFEES = \; & \gamma_0 + \gamma_1\, NB\_JUSTI + \gamma_2\, \%NEW\_JUSTI + \gamma_3\, LOGASSETS + \\
& \gamma_4\, INV\_REC + \gamma_5\, DEBT + \gamma_6\, ROA + \gamma_7\, LOSS + \gamma_8\, CROSS\_LIST \\
& + \gamma_9\, TWO\_BIG4 + \gamma_{10}\, ONE\_BIG4 + \gamma_{11}\, BUSY\_SEASON + \\
& \text{firm fixed effects} + \text{year fixed effects} + \varepsilon \qquad (3)
\end{aligned}
$$

We use the log of total audit fees paid to the pair of auditors as the dependent variable (*LOGAUDFEES*). Given that the publication of the audit fee data started the same as the JOAs requirement, we examine the effect of the JOAs using the number of matters mentioned in the justification of assessments section of the auditor report (*NB_JUSTI*) and of new matters mentioned in a given year (*%NEW_JUSTI*). If JOAs increase audit efforts and reporting costs, we expect that these two coefficients will be positive. Following previous audit fee studies (see Hay et al. 2006) we also control for various determinants of audit fees. In addition to the control variables introduced in the previous model, we control for receivables and inventory intensity (*INV_REC*) and whether the firm's year end is a 31st of December (*BUSY_SEASON*).

Model 4: Audit Report Lag Analysis

Our last model allows to assess the impact of the JOA on auditors' efficiency. We use the following regression model to examine the association between the JOA and audit report lag:

$$\begin{aligned} LOGAUDLAG = \; & \Omega_0 + \Omega_1\, JOA + \Omega_2\, JOA\_FIRST + \Omega_3\, NB\_JUSTI + \\ & \Omega_4\, \%NEW\_JUSTI + \Omega_5\, LOG\_ASSETS + \Omega_6\, DEBT + \Omega_7\, ROA + \\ & \Omega_8\, LOSS + \Omega_9\, \text{CROSS\_LIST} + \Omega_{10}\, \text{TWO\_BIG4} + \\ & \Omega_{11}\, \text{ONE\_BIG4} + \Omega_{12}\, \text{BUSY\_SEASON} + \text{firm fixed effects} + \\ & \text{year fixed effects} + \varepsilon \end{aligned} \tag{4}$$

LOGAUDLAG is the number of calendar days between the date of the audit report and the company's year-end. The coefficient on *JOA* captures the change in reporting lag associated with the JOAs reporting requirement while the coefficient on *JOA_FIRST* measures the differential impact for the first year. As for the fee model, we expect positive coefficients on *NB_JUSTI* and *%NEW_JUSTI*. The other variables are the same as those introduced in the audit fees model.

APPENDIX shows a description of the dependent variables used in each of those four models, the five test variables and the different control variables.

EMPIRICAL RESULTS

Market reaction

Panel A of Table 1 presents the descriptive statistics for the test variables and the dependent variable (|*CAR*|). For the JOA period, 9.23 percent of the JOA are first time implementation of the JOA (*JOA_FIRST*) and following the first implementation, 16 percent are new matters (*%NEW_JUSTI).* On average, the justification section of the audit report includes 2.5 audit matters and have a level of readability complexity of 169[6]. Over the sample period, the average absolute CAR around the filing date of the annual report is 0.0156. But contrary to the expectation, univariate statistics show that absolute CAR are significantly lower with JOA requirement (0.0206 without JOAs and 0.0145 with JOAs). The results in Panel B show that the introduction of JOAs has no impact on the reaction of the financial market. In model 1a, which covers the whole period 2000-2011, none of the five variables related to JOA (*JOA*, *JOA_FIRST*, *NB_JUSTI*, *%NEW_JUSTI* and *SCOLARIUS*) is statistically significant. Similar results are obtained in model 1b, which only covers a shorter period during which the auditors are required to disclose the JOA (2003-2011). Thus, we do not find any evidence that JOAs have any informative value over that provided in the rest of the annual report. [7]

[INSERT TABLE 1]

Unexpected Accruals

Panel A of Table 2 presents the descriptive statistics for the test variables and the dependent variable (|UNACC |). Even if the sample is smaller than for the market reaction model, the average for *%NEW_JUSTI* and *NB_JUSTI* are similar with values of 15 percent and 2.5 respectively. Contrary to the expectation, the unexpected accruals are larger in the JOA period (.0469) than before (.0736), but this difference is marginally significant at 10 percent.

Panel B of Table 2 shows that this difference does not hold with the multivate analysis. Indeed, the variables *JOA*, *NB_JUSTI* and *%NEW_JUSTI* are never significant whether in the full sample (models 2a to 2c) or in the JOA period (model 2d). The introduction of the JOAs does not affect the level of unexpected accruals and accordingly, there is no evidence that JOAs are associated with improved financial reporting quality.

[INSERT TABLE 2]

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[6] The different level of complexity, as measured by SCOLARIUS, are the following : - 50-89 : primary school, - 90-119 : high school, - 120-149 : college, - 150-189 : university, above 190 : expert. The JOAs' formulation are thus tailored for an university audience.

[7] It is interesting to note that, controlling for all time-invariant unobserved variables with the firm fixed-effects, none of the control variables are statistically significant, even if the models 1a and 1b accounts for 25 and 28 percent of the variance respectively.

Audit fees

As shown in Panel A of table 3, the average total audit fees for both auditors are €5.96 millions. As shown in Panel B, the coefficients on *NB_JUSTI* and *%NEW_JUSTI* are not significant, suggesting that the audit fees do not vary with the number of matters in the justifications nor the introduction of new matters in a given year. Thus, the additional work required for the determination, preparation of language for communication, and documentation of critical audit matters in the audit report seems not to alter the amounts paid by the clients. This suggests that these extra costs are marginal. It should be reminded, however, that because audit fees are not available for the pre-JOA period, we can only test the effect on audit fees of the number of matters and of the introduction of new ones, and not of the implementation of JOA section itself.

In this model, after controlling for all time-invariant unobserved variables with the firm fixed-effects, the size of the company (*LOG_ASSETS*), its cross-listing in the U.S. (*CROSS_LIST*) and the presence of a Big Four in its auditors' dyad (*TWO_BIG4* and *ONE_BIG4)* are associated with higher audit fees. These results are consistent with those of Gonthier-Besacier and Schatt (2007)

[INSERT TABLE 3]

Audit report lag

As shown in Panel A of Table 4, the average audit report delay over the sample period is 84.5 days, almost three months. The delay has reduced by only 3 days after the JOAs' introduction, this impact being non-significant. As shown in Panel B, when we control for other variables, JOAs are associated with an increase delay as evidenced by the positive and significant coefficients on JOA in models 3a, 3b and 3c. The delay does not depend on the number of justifications (*NB_JUSTI*) or on the disclosure of new matters *(% NEW_JUSTI*). However, in model 3d, for the JDA period, the coefficient on *NB_JUSTI* is positive and significant (one tail test, p=.05). These results suggest that the more iterative process to finalize the auditor's report associated with JOAs affects the timing of the auditor report.

Other variables influence the audit lag. It increases when the financial situation is more difficult, that is to say when corporate debt increases (*DEBT*) and when the performance is lower (*ROA*) or very poor (*LOSS*).

[INSERT TABLE 4]

CONCLUSION

This study examine how the introduction of JOAs in France affects the investors (market reaction), as well as the audit quality, its cost and efficiency. We find that these effects are almost inexistent: there are no clear benefits or costs. Indeed, the market does not react to JOAs, regardless the number of justifications. Besides, JOAs are not associated with better audit quality (measured with unexpected accruals) or audit fees. The only effect that we find is a slight increase in audit report lag associated when more matters are mentioned in the JOAs. These findings suggest that the JOAs disclosed by French auditors are not be as informative as regulators expected and have not altered the quality of the audit as well as its costs.

However, our results, and their potential consequences for future regulation concerning KAM, should be discussed carefully. First, the methods implemented in this paper suffer from many limitations (imperfection of earnings management measures as a proxy of audit quality; imperfection of audit fees as a measure of audit effort). Second, the French context is very specific. Almost all auditors' opinions are clean and the shareholders rarely sue auditors. In addition, the auditing standards regarding the identification are very general compared to the IAASB and PCAOB proposals.

APPENDIX DESCRIPTION OF THE VARIABLES

Variables	Description
DEPENDENT VARIABLES (One for each of the empirical models)	
|CAR|	Absolute value of cumulative abnormal return over trading days t_0 to t_{+1}, where day t is the filing date (***Model 1: Market reaction model***).
|UNACC|	Absolute value of unexpected acruals from the Jones 1991 model, modified to correct for firm performance bias, applied to total accruals, and estimated cross-sectionally by industry (1-digit SIC) and by year (***Model 2: Audit quality model***).
LOGAUDFEES	Natural log of the total audit fees charged by the joint auditors (***Model 3: Audit fee model***).
LOGAUDLAG	Number of calendar days between the date of the audit report and the company's year-end. (***Model 4: Market reaction model***).
TEST VARIABLES	
JOA	Dummy variable equal to one when the company's auditor report includes justification of assessments, and zero otherwise.
JOA_FIRST	Dummy variable equal to one for the first year the company's auditor report includes justification of assessments, and zero otherwise.
NB_JUSTI	Total number of matters mentioned in the justification of assessments section of the auditor report
%NEW_JUSTI	Percentage of new matters in the auditor's report in the justification of assessments section of the current year auditor report (number of new matters / total number of matters)
SCOLARIUS	Scolarius is a measure of readability developed by Influence Communication for French texts and is inspired by the Flesh Formula, Fog Index, Fry readability Score, and Easy Listening Formula. The higher the score the higher the level of difficulty. The score typically ranges between 50 and 250. More information on the index is available at http://www.scolarius.com.
CONTROL VARIABLES	
LN_MARKET_CAP	Natural log of Market capitalization at the end of the year
M_B	Dummy variable equal to one if the French firm is cross-listed in the U.S. and zero otherwise.
DEBT	Company's total debt divided by total assets
INV_REC	Company's inventories and receivables divided by total assets
VAR_NI_TA	Variation of the net income divided by total assets
ROA	Return on assets
IFRS	Dummy variable equal to one if the firm uses IFRS and zero otherwise
CROSS_LIST	Dummy variable equal to one if the French firm is cross-listed in the U.S. and zero otherwise
FILING_DELAY	Number of days between the filing date of the annual report and the company's year-end
TWO_BIG4	Dummy variable equal to one when two Big 4 auditors are conducting the joint audit, and zero otherwise
ONE_BIG4	Dummy variable equal to one when one Big 4 and a non-Big 4 auditor, are conducting the joint audit, and zero otherwise
LN_TOT_ASSETS	Natural log of Total Assets at the end of the year
LOSS	Dichotomous variable equal to one when the company net income is negative, and zero otherwise
BUSY_SEASON	Dichotomous variable equal to one for companies with December 31st yearend, and zero otherwise
Firm fixed effect	Firm fixed effect
Year fixed effect	Year fixed effect

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Table 1. Market reaction associated with Justification of Assessments (JOAs)

Panel A - Descriptive statistics for test variables

Variable	**Total Sample** N=815	**No JOAs (JOA = 0)** N=154	**JOAs (JOA = 1)** N=661	**Test** t value	Pr
|CAR|	0.0156	0.0206	0.0145	4.71	<.01
JOA_FIRST		0	0.0923		
%NEW_JUSTI		0	0.1604		
NB_JUSTI		0	2.4901		
SCOLARIUS		0	169.34		

Panel B - Regression results by JOA period

	Model 1a (Sample period, 2000-2011) N=815			**Model 1b (JOA Period, 2003-2011)** N=661		
Parameter	**Coef.**	**Std. Err**	**Pr.**	**Coef.**	**Std. Err**	**Pr.**
JOA	0.0088	0.0103	0.394			
JOA_FIRST	-0.0027	0.0063	0.667	-0.0014	0.0058	0.812
%NEW_JUSTI	0.0030	0.0024	0.225	0.0034	0.0023	0.151
NB_JUSTI	0.0001	0.0007	0.904	0.0001	0.0007	0.855
SCOLARIUS	0.0000	0.0000	0.752	0.0000	0.0000	0.716
ln_MARKET_CAP	-0.0001	0.0001	0.282	-0.0001	0.0001	0.265
FILING_DELAY	0.0000	0.0000	0.342	0.0000	0.0000	0.478
MTOB	0.0004	0.0004	0.362	-0.0004	0.0006	0.553
DEBT	0.0003	0.0006	0.590	0.0006	0.0007	0.446
VAR_NI_TA	-0.0025	0.0185	0.894	-0.0132	0.0193	0.494
ROA	0.0187	0.0213	0.380	0.0186	0.0237	0.432
IFRS	0.0084	0.0048	0.080	0.0064	0.0045	0.153
USA	0.0014	0.0027	0.610	0.0017	0.0030	0.566
Firm_Fixed Effects	*incl.*			*incl.*		
Year_Fixed Effects	*Incl.*			*Incl.*		
F-Value	2.27			2.130		
Adj R-Sq	0.255		<.01	0.283		

Table 2. Unexpected Accruals association with Justification of Assessments

Panel A - Descriptive statistics for test variables

Variable	Total Sample N=462	No JOAs (JOA = 0) N=29	JOAs (JOA = 1) N=433	Test t value	Pr
|UNACC|	0.0719	0.0469	0.0736	1.94	<.10
%NEW_JUSTI		0	0.1501		
NB_JUSTI			2.53		

Panel B - Regression results by JOA period

	Sample period, 2000-2011									JOA Period, 2003-2011		
	Model 2a N=462			**Model 2b** N=462			**Model 2c** N=462			**Model 2d** N = 433		
Variable	**Coef.**	**Std. Err.**	**P**	**Coef.**	**Std. Err.**	**p**	**Coef.**	**Std. Err.**	**p**	**Coef.**	**Std. Err.**	**p**
JOA	-0.0251	0.0453	0.58	-0.0272	0.0491	0.58	0.0175	0.0433	0.69			
%NEW_JUSTI				0.0009	0.0074	0.91	-0.0003	0.0079	0.97	-0.0029	0.0087	0.74
NB_JUSTI							0.0107	0.0250	0.67	0.0099	0.0257	0.70
LOG_ASSETS	-0.0082	0.0569	0.70	-0.0083	0.0571	0.70	-0.0083	0.0572	0.70	-0.0124	0.0787	0.63
DEBT	-0.0396	0.0542	0.67	-0.0419	0.0543	0.66	-0.0403	0.0544	0.67	-0.0932	0.0729	0.38
ROA	-0.0313	0.0213	0.90	-0.0320	0.0213	0.90	-0.0296	0.0213	0.91	0.1558	0.0256	0.59
LOSS	0.0241	0.2614	0.37	0.0240	0.2618	0.37	0.0233	0.2622	0.38	0.0461	0.2921	0.13
CROSS_LIST	-0.0264	0.0934	0.45	-0.0268	0.0954	0.45	-0.0266	0.0956	0.45	-0.0215	0.1063	0.60
TWO_BIG4	-0.0755	0.0266	0.19	-0.0750	0.0267	0.19	-0.0757	0.0267	0.19	-0.0706	0.0300	0.37
ONE_BIG4	-0.0128	0.0350	0.81	-0.0126	0.0353	0.82	-0.0134	0.0353	0.81	0.0224	0.0405	0.76
Firm_Fixed Effects	*Incl.*		<.01	*Incl.*			*Incl.*			*Incl.*		
Year_Fixed Effects	*Incl.*		<.01	*Incl.*			*Incl.*			*Incl.*		
F-Value	2.72			2.69			2.72			2.71		
Adj R-Sq	0.475			0.475			0.475			0.493		

Table 3. Audit fees

Panel A - Descriptive statistics for test variables

Variable	**JOA Period (2003-2011)** N=721
AUDFEES (millons)	5.96
LOGAUDFEES	7.99
%NEW_JUSTI	0.17
NB_JUSTI	2.56

Panel B - Regression results for JOA period

		Model 4 N=721	
Variables	**Coef.**	**Std. Err.**	**p**
NB_JUSTI	0.0092	0.0111	0.41
%NEW_JUSTI	-0.0125	0.0341	0.71
LOG_ASSETS	0.4924	0.0883	<.01
INV_REC	0.0854	0.0786	0.67
DEBT	-0.1761	0.0343	0.19
ROA	-0.3343	0.1980	0.32
LOSS	-0.0749	0.3347	0.05
CROSS_LIST	0.2509	0.0378	<.01
TWO_BIG4	0.5719	0.1333	<.01
ONE_BIG4	0.6329	0.0476	<.01
BUSY_SEASON	0.0504	0.1107	0.65
Firm_Fixed Effects	*Incl.*		<.01
Year_Fixed Effects	*Incl.*		<.01
R-Squared	0.979		
F-Value	236.27		<.01

Table 4. Audit lag

Panel A - Descriptive statistics for test variables

Variable	**Total Sample** N=953	**No JOAs** (JOA = 0) N=210	**JOAs** (JOA = 1) N=743	**Test** t value	Pr
Audit Delay	84.55	86.89	83.89	1.324	0.187
JOA_FIRST		0	0.109		
NB_JUSTI			2.56		
%NEW_JUSTI		0	0.164		

Panel B - Regression results

	Sample period, 2000-2011 (N=953)									**JOA Period, 2003-2011 (N=743)**		
	Model 3a			**Model 3b**			**Model 3c**			**Model 3d**		
Variables	**Coef.**	**Std.E.**	**P**	**Coef.**	**Std.E.**	**p**	**Coef.**	**Std.E.**	**p**	**Coef.**	**Std.E.**	**P**
JOA	**0.2044**	**0.0709**	**<.01**	**0.2432**	**0.0937**	**0.01**	**0.1762**	**0.0738**	**0.02**			
JOA_FIRST				-0.0355	0.0561	0.53				-0.0164	0.0515	0.75
NB_JUSTI							0.0119	0.0086	0.17	0.0160	0.0305	0.10
%NEW_JUSTI										-0.0173	0.0099	0.57
LOG_ASSETS	0.0362	0.0541	0.11	0.0364	0.0541	0.11	0.0361	0.0543	0.11	0.0061	0.0730	0.84
DEBT	0.4532	0.0471	<.01	0.4549	0.0471	<.01	0.4354	0.0472	<.01	0.4536	0.0635	<.01
ROA	-0.7322	0.0229	<.01	-0.7306	0.0229	<.01	-0.7455	0.0229	<.01	-0.9685	0.0294	<.01
LOSS	-0.0601	0.2571	0.05	-0.0597	0.2572	0.05	-0.0631	0.2571	0.04	-0.0850	0.2766	0.01
CROSS_LIST	0.0146	0.0957	0.70	0.0153	0.0957	0.69	0.0159	0.0965	0.68	0.0397	0.1077	0.36
TWO_BIG4	-0.1535	0.0310	<.01	-0.1537	0.0310	<.01	-0.1473	0.0310	<.01	-0.0168	0.0333	0.82
ONE_BIG4	-0.0933	0.0381	0.05	-0.0945	0.0382	0.05	-0.0876	0.0381	0.06	0.0301	0.0428	0.64
BUSY_SEASON	-0.0004	0.0848	1.00	-0.0009	0.0849	0.99	0.0010	0.0848	0.99	0.0164	0.0999	0.87
Firm_Fixed Effects	*Incl.*		<.01	*Incl.*		<.01	*Incl.*		<.01	*Incl.*		
Year_Fixed Effects	*Incl.*		<.01	*Incl.*		<.01	*Incl.*		<.01	*Incl.*		
R-Squared	0.697			0.697			0.698			0.763		
F-Value	15.64		<.01	15.5		<.01	15.54		<.01	16.89		<.01