

## Usefulness of the Independent Auditor's Report

### Survey to the CFA Institute Financial Reporting Survey Pool

#### About the Survey

There is a growing worldwide debate on the usefulness of the independent auditor's report. The current "pass/fail" model simply communicates that the financial statements are, in the auditor's opinion, presented in accordance with generally accepted accounting principles, but there is no information available on how the auditor addressed the risks of material misstatements identified during the audit process. While it is clear that more information about the quality of the financial statements and the audit process might be useful, it is not clear what kind of information should be communicated through the auditor's reporting model.

CFA Institute sought feedback on this topic to assist in informing the audit standards-setting bodies as they consider how to modify the Independent Auditor's Report to ensure that the user needs are being considered in any proposed changes.

#### Methodology

The online survey was sent to the 497 members of the financial reporting survey pool (an opt-in survey panel of CFA Institute members interested in providing feedback via surveys on topics related to financial reporting) on 3 March 2011. The survey closed on 10 March.

106 members participated in the survey, for an overall response rate of 21% and a margin of error of  $\pm 8.5\%$  at the 95% confidence level.

#### Summary of Findings

58% think that the independent auditor's report needs to provide more specific information about how the auditors reach their opinion on whether a company has fairly presented its financial statements in accordance with the required financial reporting standards, and 30% do not think it needs to provide more specific information.

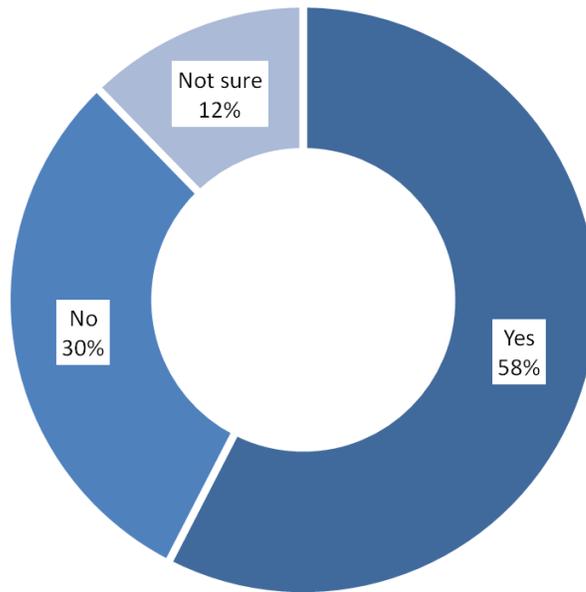
Of those who think more specific information is needed about how the auditors reach their opinion on whether a company has fairly presented its financial statements in accordance with the required financial reporting standards, the most important additional information to include is:

- Information about the independent auditor's assessment of management's critical accounting judgments and estimates (86% felt this was important to include), and
- Information about the independent auditor's assessment of the quality, not just the acceptability, of management's selection and application of accounting principles (90% felt this was important to include).

### Survey Results

58% think that the independent auditor’s report needs to provide more specific information about how the auditors reach their opinion on whether a company has fairly presented its financial statements in accordance with the required financial reporting standards, and 30% do not think it needs to provide more specific information.

**Do you think that the independent auditor’s report needs to provide more specific information about how the auditors reach their opinion on whether a company has fairly presented its financial statements in accordance with the required financial reporting**



#### Reasons why “yes”:

- *The reports seem somewhat formulaic and can hide poor audit methods.*
- *Annual reports often run to several hundred pages and unless there is a major problem with the organisation, the auditor's report says nothing. Therefore, at the moment the report can only act like a late emergency break (i.e. by the time it is in the report, it is too late).*
- *At the moment the information provided is very generic and does not differentiate between companies.*
- *Audit reports I know describe only basic information every one can find in financial statements of the audited entity. This is repetition of key financial figures.*
- *Current opinion is boilerplate.*
- *Current system had no gradation between going concern and NOT!*
- *Currently no granularity.*
- *I believe they should provide a brief summary of how they reached their opinion.*
- *I think simply saying yes or no is too dry and standards may vary. I would suggest that auditor's list all the questionable items so that the investors can decide for themselves.*
- *In general, I would prefer to receive as much information as possible on the procedures performed to obtain assurance on the financial results that have been presented.*

- *In Germany, there are detailed audit reports for the company that include the key issues identified during the audit. None of this is included in the auditor's opinion unless it is so severe that the auditor's opinion is negative.*
- *Information about what is tested and at what detail level could be material.*
- *Information on the extent/significance of unadjusted differences and disclosure deficiencies would be useful.*
- *It would be helpful to go beyond the binary response to explain how the opinion was reached and what reservations were addressed.*
- *Most of the auditor's report is standard format, no special information.*
- *Not a lot of confidence in current auditor's report.*
- *Report now contains no information.*
- *Right now it is boiler plate wording.*
- *Slightly more detail with an overview of what was reviewed. It shouldn't have to be too detailed to give away proprietary information, but in general what topics/items (i.e. customer lists) were looked over and/or discussed with management.*
- *Some highly legalised standard text that is the same for pretty much every company (as it is today) is not very useful.*
- *The analysts need to know the assumptions and the line of thinking that led the auditor to reach his/her opinion.*
- *The auditor's report is read only by those with a special interest, (e.g. knowledgeable current and prospective shareholders, analysts, etc.). These individuals might find more detail from the auditor useful. Secondly, audit opinions are almost invariably unqualified, and expressed in the standard language. This is so even for financial statements that clearly (or at least in retrospect, as seen in restatements, accounting fraud, etc.) do not represent economic reality. A detailed explanation by the auditor of key elements of the published financial statements that are contrary to economic substance would be useful.*
- *The brief disclosure rests largely on the reputations of both the auditor and the company. It isn't necessary to provide minutiae, but the auditor should disclose the types of checks it regularly engages in, the percentage of transactions it checks and detail of which aspects substantially complied.*
- *The current boilerplate language is simply not sufficient.*
- *The current reports show little reasoning and analysis.*
- *The final presentation of the statements is very boilerplate and explains nothing that was encountered during the audit. A level of "risk taking," that is how a company may interpret the standard, could be accessed by the auditing firm. However the larger issue in my mind is that of the business relationship between the client and auditor, ultimately the auditor wants the business and may bend the interpretation of standards to keep the client happy when it is not in the best interest of the user of the statements.*
- *The language is too boilerplate. The company is still the customer of the auditor. The auditor will never be honest for fear of losing the business.*
- *The only time the auditor's statement ever means anything at all is when the accounts are so grossly out of line that the auditor refuses to sign off. While the audit process itself is necessary, the auditor's report itself provides little information at all to the users of financial statements.*
- *There needs to be a greater sense of how the company's expressed the spirit of the accounting rules.*
- *To have deeper insight into how an opinion is established, underpinned. Probably the performance of the audited client is not homogenous and a simple yes may even hide areas where there is more risk.*
- *Without question.*
- *Would like to know the level of materiality used by the auditor.*
- *Yes, by stating they have assessed the risks faced by the company and how the company mitigated those risks.*

Reasons why “no”:

- *Any additional specific information would be subjective at best, and non-comparable between auditors and entities.*
- *Audit guidelines set standards for arriving at the audit opinion.*
- *Audit procedures shouldn't have to be explained in the audit report. Perhaps those wanting to know more should learn more about what audit procedures are in general. That detail in the report would add unnecessary boilerplate language because no auditor will be willing to say anything specific for fear of litigation.*
- *Financial statements prepared under US GAAP or IFRS have grown in terms of the quantity of disclosures and the detail therein. The auditor's report addresses these. I don't think requiring a more thorough auditor report gives any more comfort around the financial statements. Auditors bases for conclusions are required to be maintained by them, and most are subject to audit oversight board (PCAOB for instance anyway).*
- *I believe it is sufficient for educated investors.*
- *I can't imagine how this would look. Auditors are paid by their clients and auditors would never provide any meaningful information as it would put them in a very difficult situation between being sued or fired.*
- *I was an auditor for nine years and can tell you from experience that auditors have strict and appropriate guidelines for determining whether financial statements are materially misstated or not. Additionally, no audit partner wants the liability or the bad PR that would come from issuing a wrong opinion; this desire provides ample incentive to focus on the key areas of risk. Further, companies should not be tipped off on auditors' methodologies because that would reduce the value of the element of surprise in an audit.*
- *No need for additional disclosures in the audit opinion. Standards have been adopted by the PCAOB and approved by the Securities and Exchange Commission.*
- *Not sure you want the auditor to report auditing rules and accounting standards.*
- *The audit report is not the place to go into detail about how audits are performed. They already state that the standards under which the audit was performed (usually, Generally Accepted Auditing Standards) and those standards are too voluminous to enumerate in the audit opinion.*
- *The auditor's opinion is based on tests performed based on statistical samples, reviews, discussions with management and most importantly levels of materiality that differ among entities.*
- *The degree of detail required to make an explanation meaningful would be too long.*
- *The information will not be useful as, for confidentiality and relationship reasons, the additional information will be watered down so much so that it won't be useful.*
- *The opinion is already self explanatory. Financial statements presented fairly in accordance with GAAP and are based upon the audit within a deemed materiality level. The audit opinion is mostly meaningless.*
- *The standards required to issue an audit opinion are well-established and accepted within the US, other developed nations, and most developing nations.*
- *There are clear definitions and rules in the Generally Accepted Auditing Standard (GAAS) on these, users don't have to know every detail, in most situations they just need the auditor to "endorse" their investment/financial decision based on the audited financial statements.*
- *There are limitations to an audit in terms of scope of work, materiality, and so on.*

Reasons why “not sure”:

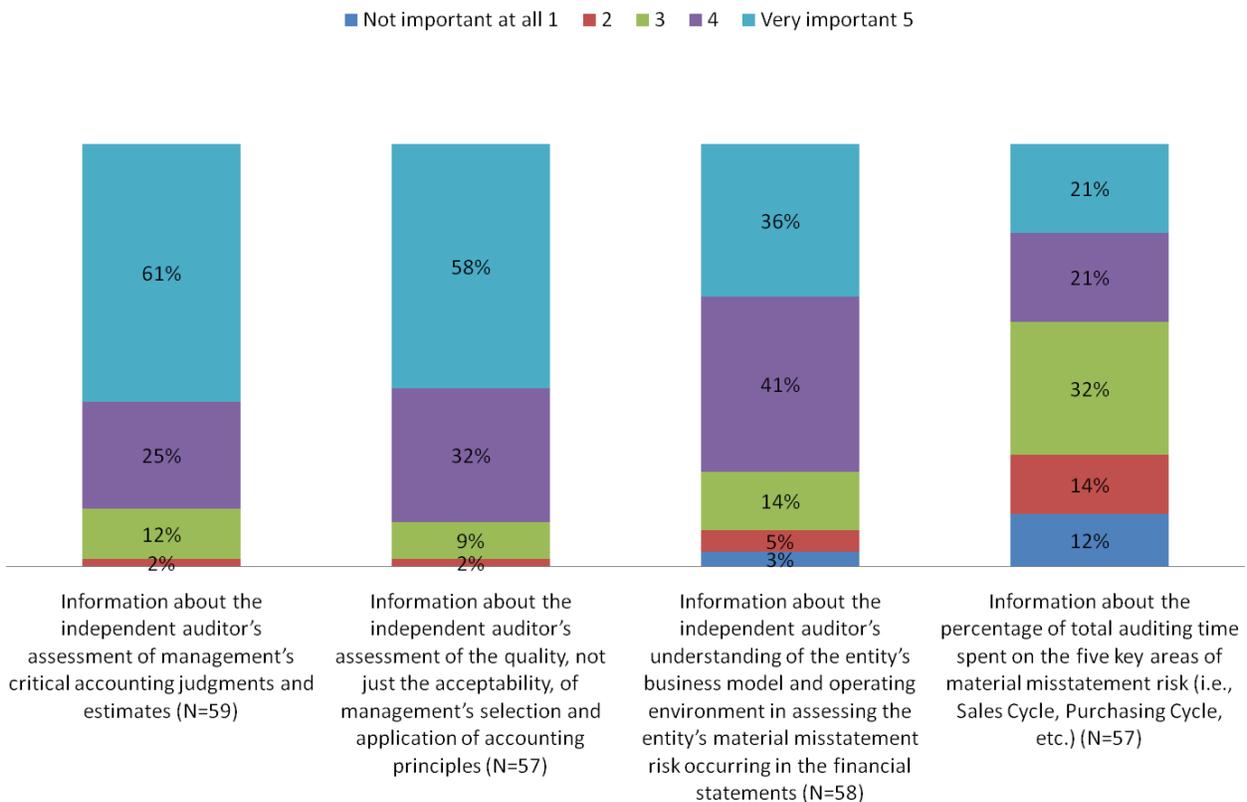
- *1) In order to present this meaningfully the report should be pretty long. Also, long explanations tend to overshadow the conclusion. 2) Auditing is a specialized area of knowledge - one needs to be an auditor to understand how the audit was done and, 3) Such format of the report would require disclosure of many judgments inherent in the audit, thus making auditors an easy target for claims. Given the current ""unlimited liability"" rules the auditors will not be able to function effectively should such requirement be introduced.*

- *As a chartered accountant, when I read the audit report, I implicitly know what Generally Accepted Auditing Standards ("GAAS") were followed and generally how they would have come to their conclusions. Now as a layman, this may not be so clear, I agree. However, without quoting GAAS and giving a full sub-report on how they derived their conclusions within the context of GAAS, what additional information could they provide which would actually be beneficial to the user. As well, at what point in time is it the responsibility of the user to be knowledgeable enough to understand that context? Long answer short, we could add additional detail there, but I do not see how useful it would be (without being presented within the context of the GAAS used).*
- *Currently, the audit opinion is more than just good or bad. There are four tiers: Good, minor bad comment, major bad comment, and no opinion. Furthermore, the opinion or minor bad comment and major bad comment need explanation and specific discussion. If more tiers are used more than the current four tiers levels, the users of the audit report may find it too complicated and confused.*
- *I am not sure that the average reader would understand the processes that auditors use to determine if the financial statements are fairly presented.*
- *Part of the value of an auditor's report is in its standard nature. By opening it up for a more "descriptive" report, you'll get a wide variety of responses on potentially similar quality financial statements. Even opinions issued by the same firm may differ due to the varying nature of the partner's opinion and audit team's work.*
- *The auditor cannot guarantee the statements.*
- *The auditor's report varies across jurisdictions. For example an audit report from an auditor in Spain will look very different from an audit report in South Africa. Furthermore the audit reports have undergone changes in the past few years. Previously there was indeed only the differentiation between "Qualified" and "Unqualified". More recently, in the Southern African context, there is a third opinion called "Matter of Emphasis". Usually the auditors have to provide details on items of concern that do not warrant a qualified audit report, but are nevertheless of concern. However despite recent advances, I do think that the informational content can still be improved and unified across different jurisdictions.*

Of those who think more specific information is needed about how the auditors reach their opinion on whether a company has fairly presented its financial statements in accordance with the required financial reporting standards, the most important additional information to include is:

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**How important is it to have the following additional information included in (or as a supplement to) the independent auditor’s report?**



Additional information they thought should be included in the independent auditor’s report includes:

- *Compliance with regulatory requirements.*
- *Coverage of various asset classes which are categorized as High, Medium & Low risk*
- *I don't believe it's necessary for knowing the auditor's level of understanding, but should be discussed if the auditor had trouble understanding a topic due to a lack of disclosure or explanation by management*
- *If the disclosure of breakdown of earnings by business category can be improved upon.*
- *If there was an increase in the total amount spend with the audit from the previous year what was the % (year-on-year) and why was it warranted (inflation, increase in the number of man hours, etc).*
- *In industries such as banking and insurance, management estimates of costs are a major aspect of preparing the financial statements. Insurer managements have to estimate claims and claims expenses, and the resultant loss reserves. Bank managements have to estimate loan impairments. These estimates*

*are necessarily imprecise, subjective, and open to abuse. In such cases auditors do not have the technical knowledge and resources to ascertain the justifiability and accuracy of management estimates. The audit report should at least confess this quite serious limitation.*

- *Information regarding the commentary provided by the Chairman, CEO and other MD&A. Is their explanation of the results reasonable?*
- *Information regarding conservatism score 1-10 grading management's accounting choices.*
- *Information on specific differences above a certain threshold (as that communicated to the audit committee/board).*
- *It would be nice to have quantifiable assessments of quality as well beyond just the auditor's opinion. Things along the lines of how many accounting practices/treatments have changed, and has this materially impacted reported results.*
- *Level of materiality.*
- *Likely misstatements, areas of complexity, independent scenario analysis of contingencies, critical challenges (sector benchmarking).*
- *Note any policies that are not consistent with competitors in the industry.*
- *Number of audit adjustments needed to make books acceptable above a certain threshold like 0.5% of total assets.*
- *Random samples model.*
- *Specific reference to items in dispute with management even if they do not reach materiality at the present time.*
- *Total compensation to the auditor.*

Additional comments about the usefulness of the independent auditor's report:

- *It would be nice to have some sort of system where management would not be in a position to influence auditors (as the case usually is).*
- *Again, I think the auditor's role is important and extends well beyond the report they provide. But that report itself is basically useless as is for users of financial statements, except when auditors refuse to sign off. That being said, adding information to these reports needs to be measured against the additional costs that will be incurred as a result. Furthermore, any new information that is provided needs to be backed up by objective and quantifiable statistics of some sort. Otherwise, the auditor's report will go from a very short, boring report that fulfills a very limited mandate, to a long, drawn out love letter to the company that adds a lot of cost without actually adding any real information to users of financial statements.*
- *Auditors are biased because they can be fired by management, thus the report should require auditor to "grade" management in some more precise manner.*
- *Careful accounting analysts know that there is some discretion about which principle to apply and how to apply it. We can reach our own assessment of whether these principles are conservative or aggressive, but it would be nice if there was some way to indicate how much discretion the auditor believed had been taken, and in theory, in which direction. (At one time some continental European companies understated earnings and assets.)*
- *Due to all of the disclaimers in auditors' reports, they don't instill a high degree of assurance that accounting rules have been followed because it is highly unlikely to catch fraud.*
- *For financial institutions, a clear breakdown per business activities of how they earn margins (decomposition of the value chain), the ROI of their business investments in projects and clear explanation of the KPI supporting the compensation packages could lead to improved transparency.*
- *I believe it serves the purpose of providing comfort to investors.*
- *I only look at the current version if it states there is a going concern opinion. Otherwise, it provides no useful information. How many of the unexpected corporate frauds had a "clean" report the year before? Nearly all. We need more shades of gray instead of black and white.*

- *I think it would be more relevant to have a report which explains in simple terms the limitations of the auditor's responsibilities and the responsibilities of management. There is a general perception that when statements are audited they have been thoroughly checked and are "accurate". This is never the case however and I believe that users need to better understand this.*
- *If independent auditors were paid properly for their work it could be better performed.*
- *If there is something to be improved, it should be the auditing process in GAAS and/or ethical and professional competence of auditors.*
- *I'm a CPA for a Big 4 public accounting firm. I'd be curious to see just how much more information would need to be disclosed and how investors would evaluate our audit approach when deciding whether or not to invest in a company. I suspect you would not see a material change in the investing habits and decisions of investors should there be any additional disclosures regarding specific audit procedures. Currently, our firm is subject to quality reviews at an individual working paper level, reviews by concurring partners prior to beginning auditing procedures and prior to the issuance of our opinion, reviews by internal inspectors, reviews by peer firms, and reviews by the PCAOB. All of which are designed to ensure that our opinion, as presented, is accurate. Should something be found that is not in accordance with GAAP that materially affects the presentation of financial information, additional disclosures are provided within our opinion. Again, I think what one really needs to consider is this; would additional disclosures about the nuts and bolts of our processes truly affect an investment decision. I can't imagine there would be a ton of instances where someone would say "I love this Company and their outlook, but they are audited by KPMG and I don't like their approach to auditing revenue, so I'll pass." I can't imagine there would be enough to justify the additional man hours are resources that will go into debating what is the proper form and depth of the additional disclosures. The PCAOB releases period reports regarding their findings of the firms they inspect; my firm included. Anyone who is truly concerned about the sufficiency of the procedures performed by an accounting firm can look to these reports to get a good sense of the types of issues (and potential deficiencies) that the PCAOB would have found. Perhaps if one firm is a repeat offender, you could avoid investing in their clients.*
- *It is extremely important that the auditor must have an excellent understanding of the business model of the client in order to come to a ""high quality"" auditor's report. At the moment, this is definitely not the case, especially in complex finance transactions.*
- *It might be a good idea to require the Audit Committee to issue a report that supplements management's reports and provides information regarding the decisions made by the committee, those risks the committee views as significant, and how the committee is comfortable that management and the auditors have sufficiently addressed such risks. For example, they might discuss the challenges faced by the adoption of a new accounting standard and indicate that significant attention was given to specific accounts affected by the adoption by both management and the auditors. They might also discuss key controls they believe address significant risks. Inevitably, there will be audit items or risk levels on which management and the auditors disagree (for example, the significance of risk associated with certain accounts). Therefore, I believe disclosure of such information would more appropriately come from the audit committee and not the external auditors as it should be the audit committee's job to judge the opinions of both management and the auditors. I believe this also would promote good corporate governance and demand a more involved audit committee.*
- *I have a feeling that the audit report is more to protect auditors themselves than to protect readers of financial statements. Moreover I can say that it is primarily legal requirement then source of useful information.*
- *Material errors in financial reporting are due primarily either to fraud or poor financial controls. Auditors identify for Audit Committees the significant deficiencies in financial controls, but do not mention them to shareholders. They could make them available to the public. Further, the public might benefit from the representation letter given to the auditor by the company's management as it usually notes a variety of company specific issues that are material management judgments critical to the reported financials.*

- *One thing about the independent auditor which should be thought about is that should the independent auditor be appointed by board and reviewed by audit committee or should it be appointed by regulatory body and reviewed by minority shareholders. The only problem of this is that the company may be blackmailed by the auditor to charge a very high fee because the company has no say in the appointment of auditor. Similarly, independent non-executive directors and valuator/appraiser (because of fair value accounting, this expert becomes very important (and have huge impact in the financial statement preparation) should also be considered be appointed by regulator and reviewed by minority shareholders.*
- *The application of accounting standards is already highly judgmental, especially across jurisdictions. Bringing different levels of auditing practices and judgments about weaknesses or error found in the audit would only make company's financial situation even less comparable.*
- *The auditor's report should explain why they believe the business is a going concern - sometimes the business is insolvent or taking substantial losses and it does not make sense. Specific statements would make them more accountable.*
- *The independent auditor's report has already grown about 3 fold since I originally articulated as a chartered accountant. I think it is incumbent on users of financial information to be more knowledgeable and more responsible in terms of that education to understand what the auditor's report is saying. The auditor's report should not supplant the actual financial information being presented, but should rather do what it is meant to do... state that the accounts have been audited and that they have been found to materially and fairly present the true position of the company.*
- *The more transparency the better. This would increase quality competition between auditors.*
- *The objective of the auditor's report is to express an opinion on the overall financial statements. By accepting a uniform standard report, it promotes credibility in the global marketplace. Most users of the report would not understand all the components in compiling an audit opinion, therefore to expand it further would not add any additional value. It should be noted that the auditor's report under IFRS is expanded from the previous US GAAS reports.*
- *The report is useful as is.*
- *The report is useful if one can read between the lines. Most of the auditor's reports appear to have a fairly standardized wording. However sometimes there are nuances, which let the careful reader note that the state of affairs is not what it should be. Arguably it would be difficult for auditors to ask them to be more direct if the company they audit pays their fees. However this problem could perhaps be addressed (albeit in generic way) by producing a template / questionnaire that becomes a mandatory part of the audit report. Such questionnaire would require the auditors to answer to specific questions.*
- *We need a completely new system that removes the fear of retribution against auditors. Public accounting should be truly public and run for the benefit of the people, much the same way the government examines financial institutions with its own examination force.*