Comment letter to respond to the PCAOB invitation to comment on its Exposure Draft Concerning the Auditor's Report on an Audit of Financial Statements

Dec 10, 2013

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 comment letter is based partly on a synthesis of the literature on the audit reporting model (Mock, Bédard, Coram, Davis, Espahbodi and Warne 2013). This comment letter is written by a subset of the synthesis authors, it expresses the views of these authors and does not reflect an official position of the American Accounting Association, the Auditing Section of the AAA, or any other organization.

Comment letter to respond to the PCAOB invitation to comment on its
Exposure Draft Concerning the Auditor's Report on an Audit of Financial Statements

I. INTRODUCTION AND COMMENT OBJECTIVES

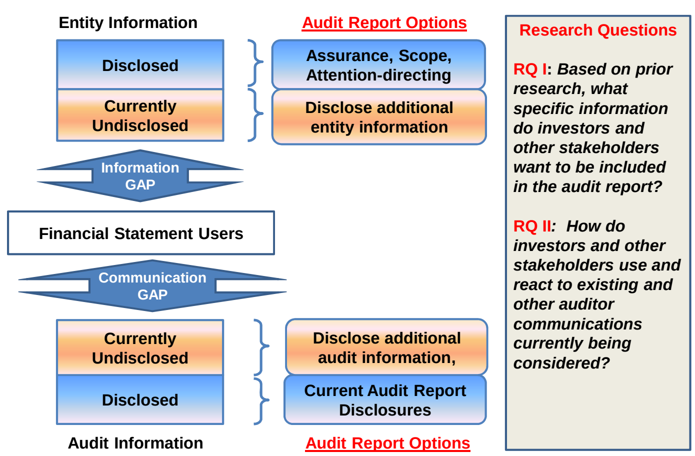
The PCAOB has invited comments concerning its Exposure Draft: *Proposed auditing standards – the auditor's report on an audit of financial statements when the auditor expresses an unqualified opinion; the auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report; and related amendments to PCAOB standards* [PCAOB Release No. 2013-005].

The proposed standards include the disclosure of additional information highlighting matters important to users' understanding of audited financial statements or the audit, information which may help close the information and communication gaps depicted in Figure 1 below. In this comment letter, we augment a synthesis of academic research [Mock, Bédard, Coram, Davis, Espahbodi and Warne, 2013] by providing an updated synthesis of academic research; indicating to what extent we believe prior research suggests that the proposed additional information is likely to close the gaps; indicating the amount of prior research evidence that is available; and identifying research gaps, that is areas where little or no prior research evidence is available.

II. FRAMEWORK, APPROACH AND COMMENT RESEARCH QUESTIONS (CRQs)

Mock et al. (2013) provide a framework based on communication theory to illustrate the basic options concerning the content of the audit report (see Figure 1). This framework separates the *expectation gap* into two components: the *information gap*, which relates to information about the entity, and the *communication gap*, which relates to information about the audit.

Figure 1: Information Gap, Communication Gap, Audit Report Options and Research Questions



In terms of research questions addressed, we focus on three Comment Research Questions (CRQs):

CRQ1. *What additional research has been published and are there findings that either significantly support or weaken the synthesis findings in Mock et al. (2013)?*

CRQ2. *To what extend is the PCAOB ED responsive to specific information investors and other stakeholders want to be included in the audit report? What information that research indicates stakeholders use and react to, is currently not provided? To what extent can the proposed disclosures be expected to close the 'gaps' identified in our prior Synthesis?*

CRQ3: *To what extent is there a "Research Evidence Gap?"*

III. FINDINGS WITH RESPECT TO CRQ 1: *What additional research has been published and are there findings that either significantly support or weaken the synthesis findings in Mock et al. (2013)?*

Our prior synthesis built on a previous research review developed by Church, Davis, and McCracken (2008) and synthesized approximately 90 studies published between 2007 and 2011. To prepare this section, we considered an additional 30 research studies and reflect on whether the prior synthesis findings are supported (strengthened) or possibly weakened. As many of these studies relate to international settings or are not directly related to topics included in the PCAOB ED, they are not considered directly to prepare this comment.

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

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

Vanstraelen et al. (2012) conducted semi-structured interviews lasting 30-60 minutes each 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 risk 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). Based on the findings of their research, the authors propose an auditor reporting model that consists of the following elements:

1) Audit scope. Include a listing of items that are part of the audit. Additional educational material could be linked to a website.
2) Audit findings. Unequivocal conclusions on each part of the audit.
3) Auditor discussion and analysis. Discussion and analysis of the auditor's findings of each part of the audit.
4) Information about the auditor. To assist users to evaluated audit quality. This could be a reference to the firm's transparency report.

Mock et al. (2013) summarize prior research with respect to stakeholders' desired information in the audit report, which is based primarily on survey data and focus groups, as follows: "Stakeholders deem the audit report as important, but they desire more information about the auditor, the audit, and the financial statements including MD&A. Audit related information desired include auditor independence, audit process, materiality, level of assurance the auditor is providing, and entity-related information including accounting policies and risk-related information."[1]

In summary, 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 they studied.

How do investors and other stakeholders use and react to existing and other auditor communications currently being considered?

Many prior studies have investigated the above research question using archival, survey, interview, focus group, and verbal protocol methods. In our prior synthesis, we categorized research into the following areas:

1) The impacts of information currently included in standard public company audit reports;
2) The impacts of information included in other types of assurance reports, such as sustainability 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, mainly an Auditor's Discussion & Analysis, expanded use of the emphasis paragraph, and information which is intended to clarify audit terminology; and
5) The engagement partner signing the audit report or being individually identified otherwise.[2]

Recent research has examined issues related to four of the above five categories. We summarize these studies and discuss their impact on our prior findings below. In addition, we discuss the results of studies that have examined Mandatory Audit Firm Rotation/Audit Tenure and disclosure of "Critical Audit Matters," two categories not covered in our prior synthesis, but that are included in the proposed standard.

[1] Mock et al., 2013, p. 331
[2] Mock et al. 2013, p. 333

The Impact of Information Currently Included in a Standard Public Company Audit Report: Information Concerning Going-Concern Opinions.

A recent US research study by Kaplan and Williams (2013) shows that when auditors issue a going-concern opinion and they subsequently face litigation, legal settlements are lower than when the auditor did not issue a going-concern opinion. Mock et al. (2013) find that the value for financial statement users of audit reports modified for going concern to be somewhat mixed. The above recent research does seem to suggest that these reports have value for the auditors as they reduce their litigation risk.

The Impacts of Information Currently Included in a Standard Public Company Audit Report: Information Concerning Internal Control over Financial Reporting

Asare and Wright (2012a) conducted two experiments to determine whether an adverse opinion for the internal control over financial reporting (ICOFR) affects investors' and analysts' confidence in the standard audit report. They find that investors' and analysts' confidence in the standard audit report [SAR] is highest when it is accompanied by an unqualified ICOFR report, and lowest when an adverse IFCOR report contains an entity-wide material weakness. In a separate study, Asare and Wright (2012b) find that equity analysts view "reasonably possible" entity-wide material weaknesses as more predictive of a future material misstatement than an account-specific material weakness. Additionally, the authors find that analysts view reasonably possible account-specific material weakness as more predictive of a future material misstatement than an unqualified opinion. These two studies suggest that analysts and investors find value in the ICOFR opinion.

Chen et al. (2013) examined the association between ICOFR audits and earnings-return associations. They find that firms with first-time, clean ICOFR audit reports have higher earnings informativeness than in the year preceding these reports when they only received financial statement audit reports. This study also suggests there are some benefits from these ICOFR audit reports.

This recent research confirms the findings as reported in Mock et al. (2013) that investors value ICOFR audits.

Additional auditor report content: Critical audit matters

Mock et al. (2013) highlight a lack of research evidence on the communication of critical audit matters. 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 followed by 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 on same theme and most of the time were a simple "cut and paste" of the previous year's description of the critical audit matter.

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 referenced a commentary by King et al. (2012) that applied insights from three academic frameworks of source credibility, accountability, and the theory of affordances. From their analysis they 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.

A recent study to address this question by Carcello and Li (2013) examined 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 compared 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. This study provides evidence of possible benefits of the audit partner signing their name. However, it does not address the question of whether the benefits exceed the costs. Of course, the other point to note that was highlighted by Mock et al. (2013) is that many countries around the world have had this requirement for years with no apparent adverse effects.

Mandatory Audit Firm Rotation/Audit Tenure

Prior academic research has documented 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).

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 research in this area contains an endogeneity problem, such as a self-selection bias of firms who voluntarily switch auditors. Also, the research findings are mixed, both between academic studies and often within specific studies. The research often examines samples, for example non-U.S. companies, that 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. Casterlla and Johnston (2013) caution the use of academic research results that may not generalize into the setting of mandatory audit firm rotation in the U.S. However, they find that eight of the 11 studies conducted in a mandatory rotation setting provide evidence that lends support to a mandatory rotation policy. This contrasts with Eqelt-Knauer et al. (2012) who 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 academic papers published recently 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. Results of recent research regarding ICOFR opinions generally conclude that investors value these opinions, which is also consistent with Mock et al. (2013). 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. 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.

IV. FINDINGS WITH RESPECT TO CRQ 2: *To what extend is the PCAOB ED responsive to specific information investors and other stakeholders want to be included in the audit report? What information that research indicates stakeholders use and react to, is currently not provided? To what extent can the proposed disclosures be expected to close the 'gaps' identified in our prior Synthesis?*

> *"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, 6).

In this section, we address CRQ2. Our evaluation is based on research cited in Mock et al. (2013) updated to include additional published academic research since 2011. The evaluation is organized around the line items in Table 2 of our prior synthesis, but is somewhat rearranged so that they correspond more closely to the requirements of the PCAOB proposed standard.

Most importantly, the Board's proposed standard would require the auditor to communicate in the auditor's report "critical audit matters" (CAMs) that would be specific to each audit. The auditor's required communication would focus on those matters 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.

The proposed standard also would enhance the auditor's responsibility with respect to "other information"[3] by adding procedures for the auditor to perform to 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. Finally, the proposed standards would (1) add new elements to the auditor's report related to auditor independence, auditor tenure, and the auditor's responsibility for, and evaluation of "other information," and (2)

[3] "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.

enhance certain standardized language in the auditor's report, including the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility to obtain reasonable assurance.

<u>Information gap items concerning the financial statements items stakeholders are interested in</u>

Tables 1 and 2 summarize our evaluation of whether the PCAOB proposed standard responds to specific entity (client) information concerning the financial statements stakeholders want to be included in the audit report and possibly help close the information gap. The 19 entity information gap line items in Tables 1 and 2 are those in Panel A of Table 2 of Mock et al. (2013), somewhat rearranged so that they correspond to the requirements of the PCAOB proposed standard. Table 1 focuses on information concerning the client's financial statements, and Table 2 contains information concerning 'other' information in the annual reports or other client communications that relate to the client's financial statements such as management forecasts.

Each table contains three columns, with Column 1 listing in total 19 possible information gap items. Column 2 summarizes the requirements contained in the Exposure Draft (ED) and our belief as to whether the ED will be responsive to stakeholder needs and will possibly help close the information gap, using a three-level scale (Yes, Possibly, No). In some cases, such as additional communications regarding going concern, the item is indicated as being one on the PCAOB agenda to be considered separately.

Column 3 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 Section V.

Items 1 to 9: As indicated in Table 1, the proposed requirement for communication of "critical audit matters" (CAMs) could potentially and significantly respond to stakeholders' demands for financial statements information items number 1 through 9 since the proposed standard requires that the description of critical matters identify, describe the considerations, and refer to the relevant financial statement accounts and disclosures. This outcome assumes that the auditor would consider these items as potentially "critical audit matters" 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 (item number 3) as "critical audit matters," but may not view many of management's judgments and estimates (item number 2) 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."

Item 10: The proposed standard does not require any new procedures or information relative to going-concern evaluation. This topic is on a separate PCAOB agenda. The gap in this area will largely remain, although CAM communications on critical audit matters may highlight risks related to the going-concern assumption.

<u>Information gap items concerning other information included in financial statements or related to the financial statements that interest stakeholders</u>

Table 2 summarizes our evaluation of nine information gap items. More specifically, it considers whether the PCAOB proposed standard responds to *other* information concerning the financial statements (or in some cases beyond the financial statements) that some stakeholders believe might benefit from auditor assurance.

Items 11, 12, 13, and 14: These entity information gap items are not addressed by the proposed standard. They may be addressed in the future. Thus, the existing gaps in these areas remain.

Items 15, 16, and 17: These entity (client) information gap items are addressed by other PCAOB standards. However, the proposed standard, if adopted, may change the language in these other reports. For example, AS 5 will be amended to assure consistency of the audit report on internal control effectiveness with an unqualified audit report on financial statements. Those changes can be expected to help narrow the information gap.

Items 18 and 19: Since non-GAAP information and MD&A are included in companies' annual reports, 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 amounts or 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' demand for assurance on them.

Summary

In summary, the proposed standard will likely close the information gap relative to some financial statement items of interest to various stakeholders. The proposed standard does not require any new procedures or information relative to going concern, which is on a separate agenda. The information gap on information other than financial statements is not generally addressed and thus will largely remain. The exceptions include non-GAAP information and information in the MD&A. The proposed auditor's responsibilities for these items likely will close the information gap.

<u>Communication gap items concerning the auditor</u>

Table 3, items numbered 1, 2 and 3 and column 2, summarizes how the PCAOB ED responds to the "communication gap" concerning the auditor and indicates our belief that the item will be responsive to stakeholder needs and will possibly help close the communication gap. Column 3 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 Section V.

Item 1: The proposed standard does not require signature or identification of the audit partner in the audit report. The existing gap in this area remains**.**

Item 2: Because it requires a new element in the auditor's report stating that the auditor is independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB, the proposed standard has the potential to reduce the communication gap by providing users information on which requirements the auditor followed. 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 is affected by the level of non-audit services provided, their nature, and the length of the auditor relationship with the company. Although the proposed standard requires disclosure of audit tenure, and fees for non-audit services are disclosed in filing documents, the nature of non-audit services will not be known by users. Accordingly, the information gap may not be significantly reduced.

Item 3: The proposed 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 close the communication gap.

<u>Communication gap items concerning the audit</u>

Table 4, items numbered 4 through 13 and column 2, summarizes how the PCAOB ED responds to the "communication gap" concerning the audit and indicates our belief that the item will be responsive to stakeholder needs and will possibly help close the communication gap. Column 3 indicates our assessment of the level of academic research that bears on the information item and to what extent significant research opportunities exist. Again, this last column is discussed in Section V.

Item 4: The proposed standard does not address the role of other auditors involved in the audit; this item is on the PCAOB agenda as a separate project. Thus, unless use of other auditors constitutes a CAM, which may be the case in some audits, the existing communication gap in this area remains.

Items 5-6: The proposed standard does not address materiality and the level of assurance given that these matters are already addressed to some degree in other standards. Implicitly, this seems to imply that the PCAOB sees these items as expectation gaps, and not communication gaps. Nomenclature aside, the proposed standard will not close these gaps.

Items 7-8: The proposed standard will likely close the gaps related to these items by clarifying the auditor's responsibilities for fraud and financial statement disclosures. The auditor's responsibility for fraud is clarified by adding the phrase, "whether due to error or fraud," to the auditor report, and that for disclosures via enhancements to the auditor's report related to the auditor's responsibility for the notes to the financial statements.

Items 9-10: Non-GAAP information and MD&A are included in companies' annual reports, and thus 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 amounts or other information in the audited financial statements. This information, however, will not be audited. Thus, while the exposure draft may narrow the information gap in these areas, it does not respond to the users' demand for assurance on them.

Items 11-12: Significant audit risk, issues of significance related to the audit scope or strategy, difficult or contentious matters, and audit procedures responsive to these risks can be expected to be addressed as "CAMs." The ED requires auditors to “communicate critical audit matters” [CAMs] – matters that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty in obtaining sufficient appropriate evidence; or (3) posed the most difficulty in forming the opinion on the financial statements. The description of critical matters can be expected to identify, describe the considerations, and refer to the relevant financial statement accounts and disclosures.

Item 13: The proposed standard enhances certain standardized language in the auditor's report, including the title of the report and audit clients. As such, the standard possibly may reduce communication gaps related to these two items.

Summary

In summary, the proposed standard will likely close the communication gap relative to many audit and auditor items of interest to various stakeholders. The proposed standard does not require any information or new procedures relative to audit partner signing the audit report or being individually identified otherwise, the role of other auditors, materiality, and level of assurance. Thus, the communication gap relative to these items will remain.

V. FINDINGS WITH RESPECT TO CRQ 3: *To what extent is there a “Research Evidence Gap?”*

Tables 1, 2, 3 and 4 also summarize in column 3 our evaluation of to what extent a “research evidence gap” exists. We indicate the level of evidence from reviewed published 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 published academic research studies beginning in 2007.

<u>Information gap items concerning the financial statements items that interest stakeholders (Table 1)</u>

Items 1 to 9: As Table 1 indicates, there is minimal to no prior research on most of the listed items that may be communicated in the auditor’s statement concerning critical audit matters. The onus will be on auditors to select the critical audit matters (CAM) to include. The newness of these disclosures creates significant research opportunities, for example to conduct studies to determine the frequency of items which are included in the CAM 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 their impacts 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 in the U.K.

Item 10: Recent research does seem to suggest value in going concern reports and the likelihood that the auditor’s CAMs will include factors related to the going concern assumption and going concern risk. Thus, there exits significant opportunities to conduct studies to determine which items will be included in the CAM, which items will stakeholders actually use and in what context, which items might be confusing or misleading, which items affect the users’ decisions, and in what form the information should be 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.

<u>Information gap items concerning other information included in financial statements or related to the financial statements that interest stakeholders (Table 2)</u>

Items 11, 12, 13, 14: Table 2 indicates there has been some, but a minimal amount of, research on all four listed items, and thus significant research opportunities. Among other things, research can investigate the effect of assurance on the quality of information such as management forecasts.

Items 15, 16, 17: Prior archival research from the 1990s on quarterly financial statements for U.S. companies shows that auditors’ reviews of these statements have value. Opportunities exit to examine whether their value has changed in a post-SOX environment. For example, a recent paper by Bédard and Courteau (2013) finds that for Canadian companies in the years 2004-2005, auditors’ reviews are not associated with greater financial statements reliability. There is minimal prior research on earnings releases, and thus significant research opportunities. In contrast, many studied have investigated ICOFR, mostly relating to large audit clients. Similar research could yield value concerning ICOFR for small firms.

Items 18 and 19: Concerning MD&A, although sparse, the evidence from survey, focus group, and archival studies indicates that users demand the information in MD&A and find it useful. However, a significant research gap exists with respect to auditor identifications of material inconsistencies with the company's audited financial statements and material misstatements of fact. Thus, significant research opportunities exist, for example, to document identified inconsistencies and misstatements and to study market effects and effects on stakeholder decisions.

Communication gap items concerning the auditor (Table 3)

Item1: Archival and experimental studies on the impact of signature on audit quality offer mixed results as do some of the related studies. Carcello and Li (2013) find that such a 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.

Items 2 and 3: The proposed disclosures related to auditor independence are somewhat novel and are disclosures in the U.S. related to auditor tenure. The mixed results of audit research concerning auditor rotation and tenure also suggest additional research. Thus significant research opportunities also exist related to these two items.

Communication gap items concerning the audit (Table 4)

Item 4 - 10: Although being addressed elsewhere, the role of other auditors in complex, multi-country audits presents significant research opportunities. Other proposed communications include disclosure of materiality and methods of determining its level, disclosure of circumstances or relationships that might affect the auditor's independence, 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 11-13: Users request additional communications concerning significant audit risks and information related to the audit scope or strategy. 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.

Conclusion concerning the research evidence gap

In summary, Column 3 of the tables documents gaps in research evidence upon which to either assess the responsiveness of the ED or the likelihood of it reducing. In some cases the research 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 proposals are relatively new. While researchers may be studying them, the output of these studies may still at the working paper stage. As noted above, we have not considered such working papers in this comment.

This research evidence "gap" suggests the need for the PCAOB to more closely work with the auditing research community and to provide or facilitate increased support to auditing researchers to study matters that will be subject to standard deliberations, including facilitating the study of the impact of both proposed and implemented standards.

Table 1: An analysis of how the PCAOB ED responds to the "information gap" concerning entity financial statement information. Items listed derived from Mock et al. (2013)

	PCAOB ED requirements and whether the PCAOB proposals respond to the information line items on a three-level scale (**Yes, Possibly, No**) [**CRQ2]**	Level of prior research (**Ample, Moderate, Minimal, None**) [**CRQ1**] and Research Evidence Gap opportunities (**Moderate, Significant**) [**CRQ3]**)
1. Accounting policies and practices 2. Management's judgments and estimates 3. Difficult or contentious issues, including "close calls." 4. Material Matters 5. Component of a larger business enterprise. 6. Significant transactions with related parties 7. Unusually important subsequent events 8. Accounting matters affecting the comparability of the financial statements 9. Most significant matters in the financial statements	"Communicate critical audit matters" [CAMs] specific to each audit **Yes** for all items included by the auditor in each client's CAM communications. Also, not being included implies items are not critical, thus the audit process did not uncover critical information that should be communicated.	**Minimal** or **No** prior research on all of the 9 listed items **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.
10. Going concern assumption	Will be addressed as a separate agenda item **No**	**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.

Table 2: An analysis of how the PCAOB ED responds to the "information gap" concerning entity 'other' financial statement information

	PCAOB ED requirements and whether the PCAOB proposals respond to the information line items on a three-level scale (**Yes, Possibly, No**) [**CRQ2**]	Level of prior research (**Ample, Moderate, Minimal, None**) [**CRQ1**] and Research Evidence Gap opportunities (**Moderate, Significant**) [**CRQ3**]
11. Management forecasts 12. Key performance indicators 13. Corporate governance arrangements 14. Sustainability information	Not addressed by the proposed standard and not on the PCAOB agenda **No**	**Minima**l prior research on the value of assurance on most types of non-financial information. **Moderate** prior research on assurance of sustainability reports. **Significant opportunities** abound, e.g., investigating the impact of assurance on the quality of management forecasts.
15. Quarterly financial statements	Addressed in other standards; the proposed standard modifies the auditor report slightly by requiring the report to be addressed at least to investors in the company and the board of directors and changing the title of the report **No**	**Ample** prior research, including a recent study. **Moderate opportunities.** For example, investigating whether addressing the report to investors has an impact on the quality of quarterly financial statements.
16. Internal controls over financial reporting	Addressed in other standards; the proposed standard modifies the auditor report slightly by adding new elements to the auditor's report on internal control related to auditor independence and auditor tenure **No**	**Ample** prior research, including many recent studies. **Moderate opportunities** focusing on the effects of additional communication requirements.
17. Earnings releases	Addressed in other standards **No**	**Minimal** prior research **Significant opportunities**. For example, investigating current auditors' practices regarding earnings release and the impact of assurance of the quality of earnings releases.
18. Non-GAAP information 19. MD&A	"Identify material inconsistencies with the company's audited financial statements and material misstatements of fact" **POSSIBLY** due to expanded auditor's responsibility for information outside financial statements	**Moderate** prior research **Significant opportunities**, for example, to document identified inconsistencies, auditors' practices, market effects and effects on stakeholder decisions.

Table 3: An analysis of how the PCAOB ED responds to the “communication gap” concerning the auditor

	PCAOB ED requirements and whether the PCAOB proposals respond to the information line items on a three-level scale (**Yes, Possibly, No**) [**CRQ2**]	Level of prior research (**Ample, Moderate, Minimal, None**) [**CRQ1**] and Research Evidence Gap opportunities (**Moderate, Significant**) [**CRQ3]**
1. Audit partner name	Item not addressed in the proposed standard **No**	**Moderate** prior research with mixed results. Recent research suggests higher audit fees, audit quality and earnings information quality. Overall, these imply signature requirement may be beneficial. **Moderate opportunities**. For example, future research could further explore benefits, especially in relation to costs.
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 **Yes**, explicitly required	**Moderate** prior research. Survey results indicate that stakeholders desire information on auditor independence. **Significant opportunities.** For example, researchers could examine the impact of such disclosure about independence on users’ perception of the independence.
3. Other [items not listed in synthesis table] such as auditor tenure	Adds new element to the auditor's report related to auditor tenure **Possibly** will close this gap, although information on auditor tenure has been available through SEC filings	**Moderate** prior research concerning mandatory rotation with mixed results. **Moderate opportunities.** Researchers could examine the effect of this disclosure on users’ perception of independence and firm rotation rate

Table 4: An analysis of how the PCAOB ED responds to the “communication gap” concerning the audit.

	PCAOB ED requirements and whether the PCAOB proposals respond to the audit information line items on a three-level scale (**Yes, Possibly, No**) [**CRQ2**]	Level of prior research (**Ample, Moderate, Minimal, None**) [**CRQ1**] and Research Evidence Gap opportunities (**Moderate, Significant**) [**CRQ3**]
4. Role of other auditors involved in the audit	Will be addressed as a separate agenda item **No**	**Minimal** prior research **Significant opportunities** exist to expand this line of research to the use of other auditors
5. Materiality	Not addressed in ED [addressed elsewhere] **No**	**Moderate** level of prior research with mixed results. **Significant opportunities**, for example to identify effects on users’ decisions.
6. Level of assurance	Not addressed in ED [addressed elsewhere] **No**	
7. 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	
8. Auditor's responsibility for financial statement disclosures	Enhancements to the auditor’s report related to the auditor’s responsibilities for the notes to the financial statements **Yes**, statements as to responsibility explicitly required	
9. Management's responsibility for the preparation of the financial statements		
10. Auditor's responsibility for information outside the financial statements	Must identify material inconsistencies Responsibility is limited **Yes**	**No** prior research **Significant opportunities.** For example, examining auditor work in this area and its association with the quality of the MD&A.
11. Significant audit risks, audit procedures responsive to these risks, and results of these procedures	Required to “communicate critical audit matters” [CAMs] – matters that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty in obtaining sufficient appropriate evidence; or (3) posed the most difficulty in forming the opinion on the financial statements. The description of critical matters would identify, describe the considerations, and refer to the relevant financial statement accounts and disclosures **Yes**, CAMs would likely involve these risks	**Moderate** Prior Research **Significant opportunities.** For example, to conduct studies to determine the frequency of items included in the CAM and study which included items affect the users’ decisions.
12. Significant risks, issues of significance related to the audit scope or strategy, difficult or contentious matters noted during the audit		
13. Other information about the audit [not listed in synthesis table]	Enhance certain standardized language in the auditor's report, including the title of the report, and addressee **Possibly**, by clarifying the language and specifying audit clients	

References

Asare, S. and A. Wright. 2012a. The effect of type of internal control report on users' confidence in the accompanying financial statement audit report. *Contemporary Accounting Research* 29 (1): 152-175.

Asare, S. and A. Wright. 2012b. The effect of change in the reporting threshold and type of control deficiency on equity analysts' evaluation of the reliability of future financial statements. Auditing: A Journal of Practice and Theory 31 (2): 1-17.

Bédard, J., and L. Courteau. 2013. Benefits and Costs of Auditor's Assurance: Evidence from the Review of Quarterly Financial Statements. *Contemporary Accounting Research* (accepted for publication).

Bédard, J., and N. Gonthier Besacier. 2013. Le paragraphe de justification des appréciations dans le rapport des commissaires aux comptes. Partie 2 : Contenu et lisibilité - théorie et pratique. *Revue française de comptabilité* (471):2-6.

Blay, A. D., M. A. Geiger, and D. S. North. 2011. The Auditor's Going-Concern Opinion as a Communication of Risk. *Auditing: A Journal of Practice & Theory* 30 (2):77-102.

Carcello, J. 2012. What do investors want from the standard audit report? *CPA Journal* 82 (1): 7.

Carcello, J. and C. Li. 2013. Costs and benefits of requiring an engagement partner signature: Recent experience in the United Kingdom. *The Accounting Review* 88 (5): 1511-1546.

Casterella, J. R., and D. Johnston. 2013. Can the academic literature contribute to the debate over mandatory audit firm rotation? *Research in Accounting Regulation* 25(1): 108-116.

Chen, L., J. Krishnan, H. Sami, and H. Zhou. 2013. Auditor attestation under SOX Section 404 and earnings informativeness. *Auditing: A Journal of Practice and Theory* 32 (1): 61-84.

Church, B. K., S. M. Davis, and S. A. McCracken. 2008. The Auditor's Reporting Model: A Literature Overview and Research Synthesis. *Accounting Horizons* 22 (1):69-90.

Ewelt-Knauer, C., A. Gold, and C Pott. 2012. What do we know about mandatory audit firm rotation? The Institute of Chartered Accountants of Scotland (ICAS). Edinburgh, Scotland.

Foster, B. and T. Ward. 2012. Are auditors' going-concern evaluations more useful after SOX? *Journal of Ethics and Public Policy* 13(1): 41-59.

Goh, B., J. Krishnan, and D. Li. 2011. Auditor reporting under Section 404: The association between the internal control and going concern audit opinions. *Contemporary Accounting Research* 30 (3): 970-995.

Kaplan, S. and D. Williams. 2013. Do going concern audit reports protect auditors from litigation? A simultaneous equations approach. *The Accounting Review* 88 (1): 199-232.

King, R., S. Davis, and N. Mintchik. 2012. Mandatory disclosure of the engagement partner's identity: Potential benefits and unintended consequences. *Accounting Horizons* 26 (3): 533-561.

Li, D. 2010. Does auditor tenure affect accounting conservatism? Further evidence. *Journal of Accounting and Public Policy* 29(3): 226-241.

Mock, T., J. Bédard, P. Coram, S. Davis, R. Espahbodi, and R. Warne. 2013. The audit reporting model: Current research synthesis and implications. *Auditing: A Journal of Practice and Theory* 32 (Supplement 1): 323-351.

Stefaniak, C., J. C. Robertson, and R. W. Houston. 2009. The causes and consequences of auditor switching: A review of the literature. *Journal of Accounting Literature* 28: 47-121.

Vanstraelen, A., C. Schelleman, R. Meuwissen, and I. Hofmann. 2012. The audit reporting debate: Seemingly intractable problems and feasible solutions. *European Accounting Review* 21 (2): 193-215.