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Comments

The PCAOB auditing standards, particularly the AS 2, are designed, among other matters, to enhance public confidence in the quality of audited financial statements. The cost of complying with PCAOB AS2, however, has been substantial¹, and to address the compliance cost related matters the PCAOB has issued AS5 to replace AS2. An important component to accomplish the objectives of AS5 is the auditor's report, which should also be assessed to enhance **the value added by PCAOB AS5 (which is designed to replace AS2). In this regard, we suggest that the wording of the auditor's report be evaluated for the following reasons:**

The auditor's communication should be structured to meet user expectations; otherwise an expectations gap (EG) similar to the one that existed for the old two-paragraph auditor's report could result. To address the EG caused by the old two-paragraph report, the Auditing Standards Board issued the SAS 58 to modify/restructure the auditor's report. **With regard to the AS2 report format, preliminary evidence (discussed below) suggests users' perceptions about readability and reliability of the report format can be substantially improved.** An approach to improve the AS5 report format would be to provide what users would normally expect from an auditor's report (e.g., structure the report format that would match/fit more closely with the users' expectations or mental frame of reference). Therefore, in addition to other issues, the questions the PCAOB/SEC could address/assess include (a) whether the auditor's report format prescribed by the PCAOB-AS 5 (or AS2) provides reasonable comfort to the

¹ Foster, Benjamin, P., W. Ornstein, and T. Shastri (2007): Audit Costs, Material Weaknesses under SOX Section 404, Managerial Auditing Journal (forthcoming July 2007 issue).

users/investors about the quality of the audited information, and (b) that AS5 report would not lead to any expectations gap from users' perspectives.

Users' expectations are likely to be influenced (and their frames of reference shaped) by significant events/outcomes. For example, because of some of the major accounting scandals, users are likely to be concerned about fraudulent financial reporting and expect some assurance from the auditor's report (with explicit statements to that effect) that the financial statements are (qualitatively & quantitatively) free of material misstatements due to fraud and/or errors.

Also, the auditor's report format as prescribed by AS5 (or AS2) contains a 'limitations paragraph' which could be misconstrued as providing less than a reasonable degree of assurance. Users' could interpret the wording as a "qualified report" or "subject to" qualifier regarding the effectiveness of internal control leading them to perceive that the quality of financial statements could also be adversely affected. Therefore, two matters in the AS5 prescribed auditor's report format might not be consistent with the expectations of users these are (a) absence of explicit reference to auditor's fraud detection responsibility, and (b) presence of the "limitations paragraph".

Some Empirical Evidence: Evidence suggests that a "limitations paragraph" in the auditor's report may adversely influence users' perceptions about the subject matter audited. For example, a study² examined users' and auditors' perceptions about the *readability*, the *reliability* and the *liability* (responsibility) assumed by the auditor. This study used responses from 123 professional lenders and financial analysts and 122 audit managers and partners, and a version of the auditor's internal control report (ICR) similar to the SSAE #2 format, which contains a "limitations paragraph". The study found that users perceived that (a) the ICR with a "limitations paragraph" provided less than a reasonable degree of assurance, (b) the ICR format without a "limitations paragraph" is likely to enhance users' understanding of the message communicated by the audit report, (c) a report format without a "limitations paragraph" may narrow a potential expectations gap, and (d) the inclusion of fraud wording in the report format

² Foster, Benjamin, P., Willie Gist, Guy McClain, T. Shastri (2005), A Note on Pre-Sarbanes-Oxley Act Users' and Auditors' Perceptions of a Limitations Paragraph in the Auditor's Internal Control Report, *Research in Accounting Regulations*, Vol. 18, 2005, pp. 195-217. The authors used data collected from a field experiment in 1991. At that time the most current version of the ICR format was Auditing Standards Board File #4287. File #4287 was the basis (with few changes) for Statement on Standards for Attestation Engagements (SSAE #2) issued in 1993.

without a “limitations paragraph” further enhanced the users’ perceptions regarding *readability* and *reliability*.

Also, the study indicated that a report format structured along the lines of SAS 58 report is likely to more closely match with the users’ mental frame of reference for auditor’s report. One reason could be that SAS 58 report format has been in use since 1988, and was developed from the earlier version of the two-paragraph auditor’s standard report that was in use for nearly 40 years. Both (two-paragraph and SAS 58) report formats do not contain a “limitations paragraph.”

By contrast the AS2 (or AS5) internal control report format by including a “limitations paragraph” deviates from the SAS 58 report structure, and such a deviation in structure may not be compatible with users’ expectations. A recent study³ replicated the study by Foster et al. (2005)² with ninety-two MBA (finance students). For experimental/treatment manipulation, the study used three versions of internal control report (ICR) formats: (1) the PCAOB AS2 mandated format which contains a “limitations paragraph” (labeled as ICR2), (2) a format similar to ICR2, but without the “limitations paragraph” (labeled as ICNL), and (3) a format similar to ICNL, but incorporating a statement regarding the auditor’s fraud detection responsibility consistent with the Statement on Auditing Standard No. 99 (labeled as ICNLF).

The results of this study indicate that the “limitations paragraph” adversely affects user perceptions regarding the *readability* and *reliability* dimensions of ICR2 (the PCAOB-AS2 mandated internal control report format). Consequently, users may perceive that the ICR2 format as providing less than a reasonable degree of assurance. By contrast, users evaluated *readability* and *reliability* dimensions favorably for the internal control report format (ICNL) structured along the lines of SAS 58 without the “limitations paragraph,” possibly because ICNL may be consistent with their (users’) mental frame of reference. Also, users’ perceptions indicate an enhanced improvement in the *readability* and *reliability* when fraud wording was incorporated into the report along the lines shown in ICNLF report format.

³ Foster Benjamin, P., Guy McClain, and T. Shastri (June 2007): The effect of a limitations paragraph on users’ perception of the auditor’s internal control report, Working Paper, School of Accountancy, College of Business, University of Louisville.

Recommendations for consideration:

Based on preliminary data from the above studies, we suggest the following:

- Evaluate the appropriateness of keeping the “limitations paragraph” in the AS5 report format from users’ perspectives.
- Examine the effect on the value added by the AS5 (from users’ perspectives) if the auditor’s report included fraud wording to reflect auditor’s responsibility for consideration of fraud in audits as per SAS 99.
- Undertake more extensive studies to obtain data relating to structuring auditor’s communication format(s) that would close the perceived communications gap, if any, and explicitly provide a reasonable degree of assurance that the financial statements are free of material misstatements due to fraud and/or errors.