

AUDIT REPORTING: MISSION IMPOSSIBLE?

Special Thanks

I am deeply honored to be here today. When I came to NHH on my sabbatical leave in January 1991, I never dreamed that I would be a member of the accounting faculty for 20 years and be the recipient of an honorary doctorate from this great institution. There are a number of people that I want to thank. First and foremost, I want to thank my wife, Teddie. If it weren't for her, I wouldn't be standing here today. I would also like to thank my good friends at NHH and who, I'm sure, are responsible for my being awarded this degree:

- Arne Kinserdal who hired me in 1991.
- My many friends and colleagues on the faculty: Froystein Gjesdal, Atle Johnsen, Arne Riise, Trond Bjornenak, Arthur Brudvik, and Norvald Monsen; all of whom have been great friends for all these years.
- Aasmund Eilifsen and his wife, Bente, who are very special friends of Teddie and I. We have spent many happy times with them.
- A special thanks to Elisabeth Stiegler, a great friend and special person AND the power behind the scenes in the Department of Accounting, Auditing and Law!

- I also want to thank PwC for their support of my professorship at NHH.

Introduction

We were asked to make a presentation on issues related to our research. Virtually all of my research has been devoted to investigating auditing and in particular auditor judgment at the task level. Some of the issues I have researched include materiality judgments, the effects of decision aids on judgment, biases that affect judgments, and evidence evaluation issues.

Today I will talk about a topic that has been ingrained in my research agenda. In a number of my research projects, the experimental instruments that I used to test specific issues relied on audit reporting as a context. I have titled my presentation “Audit Reporting: Mission Impossible?” The discussion that follows has implications for both auditing scholars and audit practitioners.

I assume that most of the people in the audience have some familiarity with auditing. Auditors (state authorized auditors, CPAs, or CAs) serve a valuable economic function by reducing the information asymmetry that exists between managers and owners of an entity. The only observable output of the auditor’s work effort is an audit report or opinion on an entity’s financial statements.

My presentation today will discuss two research questions:

RQ1: How can auditors provide an audit report that is more responsive to the real or perceived needs of the various users groups who rely their work product?

RQ2: Given the complexity of business transactions today (e.g., various types of estimates), how can auditors provide “reasonable or high assurance” that the financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of a company and its financial performance and its cash flows in accordance with the applicable financial reporting standards?

As my presentation will suggest, I am not sure that audit researchers, practitioners, or regulators can provide an adequate answer to either research question without some significant changes in current accounting and auditing regulations. I also want to make it clear that I am not being critical of auditors. They make their judgments based on current accounting and auditing guidance.

Before proceeding, let me set up the current audit standard setting process internationally and in the US. I do this so that I can use the acronyms for the various players without confusing the audience. I include the US specifically because of the supposed transnational power of one of its regulators. The International Auditing and Assurance

Standards Board (IAASB) is responsible for international auditing standards or ISAs. In the US, we have two audit standard setters: (1) the Public Company Accounting Oversight Board (PCAOB) who is responsible for publicly traded companies and (2) the AICPA's Auditing Standards Board (ASB) who is responsible for private company auditing standards. I served on the ASB from 2002 – 2005: a time when the PCAOB assumed its current role. The PCAOB is a nonprofit corporation established by the US Congress to oversee the audits of public or listed companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. Non-U.S. accounting firms that play a substantial role in preparing such audit reports are subject to their rules, and must register with the PCAOB.

RQ1: Changing the Auditor's Reporting Model

Over the last 75 years, there have been very few changes to the standard audit report (SAR) both internationally and in the US. Internationally, if a country did not adopt ISAs, they tended to use an audit report that matched their country's statutory requirements. The recent EU Green paper stated that the ISAs have either been adopted or are in the process of being adopted by a majority of Member States and are also being applied by the major networks of audit firms. Thus, most listed companies in Europe received a report that follows the standard wording required by the ISAs. In some countries, there may be some

minor wording for statutory purposes.

In the US, a standardized form of the audit report was adopted in the 1940s. In 1988 the US's ASB made the first changes to the standard audit report (SAR). These changes were in reaction to what is referred to as the "expectation gap." This term means that there is a "gap" between what users of the audit report believe the auditor does and what the auditor actually does. In my opinion, the changes made in 1988 did very little to reduce the expectation gap. Most audit research done at the time would support my conclusion. Since 1988, the only changes made to the standard audit report for public companies was a reference PCAOB standards and the report on internal control required by Section 404 of SOX. Recently, the IAASB and ASB have issued a slightly revised version of the SAR.

It should be noted that the current auditor's report is a *pass/fail* model.

My main motivation for RQ1 is that both the IAASB and PCAOB have issued documents that could drastically change the way auditors report: (1) IAASB's Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change* and (2) PCAOB's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*. The end of the comment period on both documents is this

month.

Both regulators have conducted outreach sessions with various types of users. Information from these sessions signal that (1) users indicate that the auditor's report has value, (2) auditors know more about the entity than what is reported in the SAR and the users want auditors to report that information, and (3) some users believe that the content and structure of the SAR could be improved. So it appears that in addition to an expectation gap, there is an "information gap." That is, there apparently is some difference in the information that users want from auditors for making informed investment and fiduciary decisions and what is currently available publicly.

The IAASB and AIPCA sponsored four research projects to examine various issues related to audit reporting. After a quick read of these studies, I think that the results support the continued presence of both an expectation and information gap and that closing these gaps will not be easy.

Returning to the IAASB Consultation Paper and the PCAOB's Concept Release, each of them proposes changes - some significant and some relatively minor - to the auditor's reporting model. The alternatives for changing the auditor's reporting model include:

- Auditor's Discussion and Analysis;
- Required and expanded use of emphasis paragraphs in the

auditor's report;

- Auditor assurance on other information outside the financial statements; and
- Clarification of language in the standard auditor's report.

All of the alternatives would retain the pass/fail opinion of the SAR.

AD&A: The Auditor's Discussion and Analysis alternative could provide investors and other financial statement users with a view of the audit and the financial statements "through the auditor's eyes." The AD&A would be a supplemental narrative report that would accompany the standard audit report. The intent of an AD&A would be to provide the auditor with the ability to discuss in a narrative format his or her views regarding significant matters. It also could include a discussion of the auditor's views regarding the company's financial statements, such as management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls." In my opinion, this alternative will face substantial resistance from the accounting firms for a number of reasons; including its affect on their relationship with management and the audit committee, and possible litigation issues.

Explanatory Paragraphs: This alternative would require the use of emphasis paragraphs in all audit reports and expand emphasis paragraphs to highlight the most significant matters in the financial statements and to identify where these matters are disclosed in the

financial statements. Emphasis paragraphs could be required in areas of critical importance to the financial statements, including significant management judgments and estimates, areas with significant measurement uncertainty, and other areas that the auditor determines are important for a better understanding of the financial statement presentation. I think that this alternative could be adopted but I would be worried about having too many EPs accompanying the auditor's opinion.

Other Assurance: Current auditing standards require that the auditor read the other information that accompanies the financial statement to ensure that the information is consistent with the financial statements. The auditor's reporting model could be enhanced if auditors were required to provide assurance on information outside the financial statements, such as management discussion and analysis or earnings releases. Some believe that an auditor providing assurance on information outside of the financial statements could improve the quality, completeness, and reliability of such information, providing investors and other users of financial statements with a higher level of confidence in information about the company that is provided by management. There are standards currently on the books of the regulators that would allow auditors to provide such assurance. I have some concerns here related to whether providing such assurance might delay earnings releases or quarterly and annual filings.

Enhanced Language: Regulators could enhance the auditor's reporting model by clarifying language in the existing SAR. While this alternative would not significantly expand the content of the auditor's report, it could provide additional explanation about what an audit represents and the related auditor responsibilities. Possible matters that could be clarified in the auditor's report with additional explanation include:

- What does the term “reasonable assurance” mean?
- Expanding the description of the Auditor’s Responsibility for Fraud and Financial Statement Disclosures.
- Expanding the description of Management’s Responsibility for the Preparations of the Financial Statements.
- Auditor’s Responsibility for Information Outside the Financial Statements;
- Auditor Independence.

This solution might be the easiest to implement for the regulators. However, I have serious reservations whether users will understand the subtle meanings of some of these terms.

RQ2: Can Auditors Provide Reasonable Assurance That the Financial Statement Present Fairly in all Material Respects Given Estimation Uncertainty Related to Estimates

In discussing RQ2, I rely extensively on a recent paper by Christensen, Glover and Wood (CGW) entitled “Extreme Estimation Uncertainty In Fair Value Estimates: The Implications For Audit Assurance.” Steve Glover is a coauthor with Aasmund and I on our auditing textbook. I invited Steve to present this paper at UNLV earlier this year.

In their paper, Christensen et al. present two examples, Wells Fargo and GM, where small changes in the inputs to the models used to determine the financial statement value of selected accounts could result in value changes that are multiples of overall audit materiality. For those individuals not familiar with auditing, materiality is an amount, determined by the auditor, by which the financial statements could be in error and that amount would not affect the decisions of users. Materiality, as determined by the auditor, is used to set the scope of the audit. One typical benchmark for determining materiality is 5% of NIBT. That is the amount used by Christensen et al. in their study.

Estimation uncertainty is defined in auditing standards as “the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.” I think that it is fair to say

that no amount of auditing can remove the extreme estimation uncertainty for some fair value estimates that are based on models using management's subjective judgment and volatile inputs.

Wells Fargo. In 2008, Wells Fargo had a total of \$99.7 billion in mortgaged-backed securities on its balance sheet. It disclosed in the notes to its financial statements the impact that a 200 basis point (bps) change in interest rates would have on the fair value of the mortgage-backed securities. Wells Fargo's financial statements did not disclose the original interest rates used in the valuation model, nor did they convey whether 200 bps provided a reasonable range of uncertainty in interest rates. During the 2003-2008 time period, significant volatility in interest rates occurred. The prime interest rate went from 4 percent in 2003, to 8.25 percent in 2006, then back down to 3.25 percent at the end of 2008. These changes are 2 to 2.5 times the 200 bps used as a sensitivity analysis in Wells Fargo's disclosures.

Christensen et al. show that a 200 bps change in the interest rates would have produced changes in the mortgage-backed security account that are many times greater than the amount of materiality used by the auditor. For example, in 2008, Wells Fargo had \$3.26b of NIBT. This would result in setting materiality by the auditor at \$163m. A 200bps increase in interest rates results in an \$8.8b decrease in the fair value of the MBS. That change is 54 times materiality.

General Motors. In 2009, General Motors came under the scrutiny of the Securities and Exchange Commission (SEC) for alleged manipulation of inputs to models used to develop accounting estimates (SEC vs. General Motors 2009), including using aggressively high discount rates and expected returns on pension plan assets. According to the SEC, manipulating such inputs resulted in significant misstatements to pension balance sheet accounts, as well as to pension expense, which had a direct impact on operating income.

Pension accounting involves determining values for pension assets and liabilities using inputs such as estimated discount rates. Management has latitude in selecting the interest rate estimate used. The broader the range, the more opportunity management has to select a value that is favorably biased to achieve management's reporting goals.

Christensen et al. report that in 2001, GM used a 7.25 percent discount rate and planned to use a 6.75 percent rate for 2002. In pension accounting, the higher the discount rate, the lower the pension liability and pension expense. However, the 6.75 percent could not be justified by the Solomon Smith Barney yield curve, the primary basis for discount rates used by GM in prior years. GM justified the use of 6.75 by indicating it was more in line with Moody's index, which as of the end of 2002, was 6.63. To justify a rate above both Moody's and Solomon Smith Barney, GM indicated it relied on a "survey" of other companies.

GM's auditor suggested that a rate of 6.50 percent seemed more appropriate.

In its 2002 10-K, GM disclosed that a change in the discount rate of 25 bps would impact its 2003 pre-tax pension expense (and net income) by \$120 million, its 2002 pension obligation by \$1.8 billion, and 2002 equity by \$1.1 billion. Using the 5% of NBIT, GM's 2002 audit materiality was \$104 million. Thus, GM was able to significantly lower its 2002 obligation by multiples of materiality and significantly increase 2003 net income by using a higher discount rate. Regardless of whether GM intentionally manipulated the rate or used aggressive inputs, the fact that a seemingly "reasonable" range (from Solomon Smith Barney's 6.0 to the survey's 6.75) can produce changes in the estimates that are many times greater than audit materiality highlights the effects of estimation uncertainty in reported measurements.

GM also used aggressive expected rates of return on plan assets, another key input chosen by management. The effects of changing such inputs again led to amounts many times greater than materiality.

The Wells Fargo and GM examples illustrates that the significant estimation uncertainty of some inputs can cause point estimates reported in the financial statements to vary widely from the reported values.

Is There a Solution?

I wish there was a silver bullet to help auditors deal with these situations. It seems to me that accounting *and* auditing regulators are going to have to respond to this issue by providing better guidance. I understand that there are deliberations going on at the IASB and FASB on better ways to present financial statement information. Maybe it is possible to present the financial statement in a format that will recognize the estimation uncertainty that exists for certain financial statement accounts.

Auditing standards require auditors to determine whether the financial statements contain any estimates with high estimation uncertainty and whether the uncertainty gives rise to significant risks. For such estimates, auditing standards require the auditor to make additional evaluations, including understanding management's model, testing controls, and considering the reliability of data. That includes developing a range to evaluate the reasonableness of the accounting estimate. However that range has to be "*equal to or less than performance materiality.*" Given the two examples presented, users, regulators, and standard setters may have an unrealistically high expectation of the degree of precision and assurance associated with highly uncertain estimates recognized and reported on the face of the financial statements.

There may be a possible number of actions that auditing regulators could take. One goes back to RQ1. It may be possible to disclose more information in the auditor's report about such accounts. I understand that France now requires auditors to describe in explanatory paragraphs below the standard audit opinion the justification for their assessments as well as how they obtained assurance on select significant accounts (Article L.823-9 of the French Commerce Code). Another approach may be for the auditor to provide different levels of assurance on different parts of the financial statements.

Concluding Comments

My purpose today was to discuss two research questions related to audit reporting. I think that both of these RQs offer opportunities for audit scholars. The discussion also points out the difficulty that audit practitioners face in dealing with the complexities of the current business environment.

In closing, I again want to thank everyone at NHH for bestowing this honor on me.