

The Value of Audit

Research project commissioned by
the Standards Working Group / Global Public Policy Committee

Maastricht

Accounting, auditing & information management

Research

Center

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1 March 2010

Preface

This report presents the results of a research project on the value of audit. The project was commissioned by the Standards Working Group (SWG) of the Global Public Policy Committee (GPPC). The GPPC is the global forum of representatives from the six largest international accounting networks – BDO, Deloitte, Ernst & Young, Grant Thornton, KPMG, PricewaterhouseCoopers. Its public interest objective is to enhance quality in auditing and financial reporting.

This research project has been conducted by the Maastricht Accounting, Auditing and Information Management Research Center (MARC) of Maastricht University. MARC has final editorial responsibility for this report. Therefore, the conclusions and recommendations of this report are not necessarily shared by the SWG or GPPC.

The research team would like to express its gratitude to over 200 chief financial officers, audit committee members, and financial analysts who participated in this study. Their contribution to this project, including many critical remarks and discussions, was indispensable. Also, we would like to thank Chrystelle Richard (ESSEC Business School, Paris) for her help in interviewing several chief financial officers and audit committee members. Finally, we would like to thank Borut Bokhove, Mario Kohl, Frederik Metselaar, and Timo Schmitz for their assistance in collecting various data needed for this project.

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Maastricht, 1 March 2010

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Executive summary

This study provides empirical evidence on the value of the audit of financial statements in today's economy as perceived by financial analysts, chief financial officers (CFOs) and audit committee members. Our major conclusions are the following.

First, we conclude from a survey of financial analysts that the auditor's work is valuable for financial analysts as it increases their confidence in and reliance on financial statements.

Second, we conclude from interviews with CFOs and audit committee members that the audit of the financial statements meets their key expectations and is considered to be a useful activity. Furthermore, CFOs and audit committee members value the communications with the auditor in the audit process, and find it useful to work with the auditor on financial reporting issues. On a scale from 1 to 10, where 1 = no value and 10 = excellent value, the respondents' overall score for the value of audit was 7.3.

However, both parties highlighted matters for further consideration in the following areas:

- i. First, respondents would like to see the audit model reconsidered to offer a less compliance driven, more comprehensive approach that additionally offers a broader, more holistic view of the business.
- ii. Second, CFOs envision an enhanced role for the auditor as an independent expert to check and challenge their views on critical and complex issues.
- iii. Third, close attention should be given to the content of management letters as these are perceived to be a valuable form of communication both by CFOs and audit committee members.
- iv. Fourth, the communication from the auditor to the company should be clear and unequivocal.
- v. Fifth, respondents value the auditor's insights on the company's risk management system.
- vi. Sixth, auditors in all jurisdictions should strive for a universally consistent interpretation and application of standards; policy makers and regulators should support common standards and consistent regulatory oversight across jurisdictions.
- vii. Seventh, respondents believe that financial reporting does not always provide the information needed for investors to understand what is happening within a company. In order to maintain the relevance of auditing in the future, auditors should keep working on evolving the business reporting model, together with policy makers and standard setters.
- viii. Finally, respondents would welcome increased cooperation between a company's internal (or operational) audit department and the external auditor as they perceive it can create value for both the auditor and the auditee.

The findings presented in this study are based on 30 interviews with CFOs and audit committee members of publicly listed companies in Belgium, France, Germany, the Netherlands and the United Kingdom, and a survey of a representative sample of 171 financial analysts who follow publicly listed companies in Germany, the Netherlands and the United Kingdom. Hence, the results give insight on the value of audit as perceived by three capital market stakeholders: (a) preparers of financial reports; (b) those charged with financial reporting oversight; and (c) users of financial reports.

Our key findings resulting from interviews conducted with CFOs and audit committee members are the following:

- i. Clearly, one of the key expectations of respondents is the formal attestation of the financial statements. CFOs indicate that they expect the external audit to act as an incentive to encourage their company's subsidiaries and departments to maintain accurate financial records and produce reliable financial statements, and that they expect the auditor to act as a sounding board on critical and complex issues. Audit committee members wish the

auditor to evaluate the reliability of their internal control system, provide insights on the company's risk management system, and in general to offer a broader, more holistic view of the business. Auditors generally meet respondents' key expectations, although in part due to the constraints of the current audit model, respondents perceive that there is room for improvement in the area of internal control, fraud, and risk management. Respondents want the auditor to go beyond the current remit of the audit function and additionally provide a broader, more holistic view concerning the business. We note that there appears to be an expectation gap in particular with respect to internal control, as the international standards on auditing do not require the auditor to evaluate the reliability of the internal control system, except to obtain an understanding of the control environment sufficient to assess risk of misstatement and design the appropriate audit response.

- ii. Both CFOs and audit committee members consider the auditor to be a useful source of knowledge, an advisor on accounting issues, and "a second pair of eyes" through auditing the accounts of the business. CFOs in particular, however, observe a decrease in the usefulness of the financial statements, and by consequence the audit, mainly because investors have trouble understanding financial statements due to the myriad of changes in financial reporting regulation. Without implying that auditors today find such a role appropriate, CFOs envision an enhanced role for the auditor as an independent expert on critical and complex issues in order to ensure that the audit is not purely compliance driven, with auditors adopting a checklist approach.
- iii. Both groups of respondents consider the auditor's corrective role to be useful, but particularly in larger, well-managed businesses, this is less important than the auditor's preventative role. In general, audit committee members attach more value to the preventative role than CFOs.
- iv. All respondents consider communication with the auditor to be useful, both during and after the audit. They are particularly satisfied with the open dialogue and the timeliness and frequency of communication, and observe a tendency towards more transparent communication. Regarding the management letter, CFOs appreciate parts that relate to internal control over financial reporting, audit findings and proposed adjustments, IT security issues, and insights offered on the company's risk management system. Audit committee members are also very satisfied with the auditor's communication of the audit findings and appreciate the auditor's focus on material issues. However, they would also appreciate more insights on the company's risk management system. Respondents see room for improvement in some areas, as they find that management letters become thinner every year and discussions more formal but less informative. CFOs observe some lack of clarity of messages, particularly in relation to complex financial reporting issues. This can arise where the audit engagement partner gives an initial view on a technical matter, and then consults with the audit firm's technical office, and subsequently revises their initial view. Audit partners need to communicate clearly the audit firm's final position on technical matters.
- v. Respondents generally consider dialogue with the auditor on financial reporting issues to be useful. Although most companies have their own IFRS specialist, the auditor's knowledge of complex IFRS issues is particularly highly valued. CFOs also appreciate the audit firms' worldwide presence, and with that the firms' knowledge on financial accounting rules in various countries. However, they also note that the local auditors' knowledge and quality can differ from country to country, and it seems that – especially with respect to countries with a less-developed accounting profession – audit firms can improve universally consistent interpretation and application of standards.
- vi. Other findings indicate that (a) the majority of the audit committee members find that the auditors' input, through their challenge to management, helps in dealing with the consequences of the current financial crisis for their company's reporting; and (b) according to the respondents added value can be created for both the auditor and the auditee when there is increased cooperation between the auditee's internal (or operational) audit department and the external auditor. Such cooperation should however be critically assessed as it could compromise the perceived independence of auditors.

- vii. On a scale from 1 to 10, where 1 = no value and 10 = excellent value, the respondents award an overall score for the value of audit of 7.3. Overall, we can therefore conclude that our respondents perceive a positive value of the audit and the auditor and find that the auditor meets their expectations.

From our survey of financial analysts, we draw the following key findings:

- i. We find that analysts have confidence that the annual financial statements of companies that they cover (a) fully comply with applicable accounting standards; and (b) are free from material misstatements, both intentional and unintentional.
- ii. Analysts indicate that they rely on the annual financial statements of companies that they cover when analyzing companies' equity value.
- iii. We find an economically large and statistically significant increase in confidence and reliance on annual financial statements when these statements are audited, compared to a hypothetical situation in which the statements are not audited. This suggests that analysts generally perceive that the auditor's work is valuable to them by increasing their confidence in, and reliance on, the annual financial statements.
- iv. Respondents agree that an independent review of the interim financial statements of the companies that they cover improves the reliability of the financial information included in these statements.
- v. Respondents agree that an independent audit instead of an independent review of the company's interim financial statements further increases their overall reliance on these statements. This finding further strengthens the view that respondents find that auditing improves the usefulness of financial statements.
- vi. Analysts find that the statutory auditor currently adds value by: (a) assuring that a company complies with applicable accounting and disclosure regulations; (b) questioning companies' internal control processes and systems; (c) making the company aware of the financial reporting risks to which the company is exposed; (d) improving companies' financial reporting and disclosure decisions; (e) providing a disincentive to commission of fraud by managers and employees; and (f) improving access to capital and lowering companies' cost of capital (both debt and equity).
- vii. We find very few significant differences in opinions between responses from analysts of companies listed in the UK, which were obtained in June and July 2009, and responses from analysts of companies listed in the Netherlands and Germany, which were obtained between June and August 2008. This suggests that the perceived value of audit has not suffered from the dramatic decline in stock prices in and after September and October 2008. The only statistically significant difference observed is that analysts have become less optimistic about the beneficial effect of audit on companies' cost of capital and access to capital. Deteriorated lending and financing conditions are a plausible explanation for this finding.

Overall, the evidence provided in this study is useful to inform the current debate on the value of audit in the academic, audit, regulatory, business, and investment communities. Hence, it can help governments, policy makers and standard setters, as well as the accounting and finance profession as a whole, to make informed decisions.

Chapter 1: Introduction

1.1 Main objective

There is at present a lack of contemporary empirical evidence on the value that the financial statements audit has in today's increasingly globalized and complex economy. In order to inform the current debate regarding the value of audit in the academic, audit, regulatory, business, and investment communities, the main objective of this research project is to fill the gap that exists in academic research by providing contemporary evidence on the value of audit as perceived by the following stakeholders: (a) preparers of financial reports; (b) those charged with oversight of financial reporting; and (c) users of financial reports.

1.2 Research questions

Given the aim of our project, we formulate the following research questions: (a) What is the value of audit as perceived by chief financial officers (CFOs)? (b) What is the value of audit as perceived by members of audit committees? and (c) What is the value of audit as perceived by financial analysts?

We select CFOs because they are the primary representatives of preparers of financial statements. We focus on audit committee members because they can be regarded as one of the primary groups charged with oversight of financial reporting and disclosure. Because of their role, function, and direct involvement in the financial reporting process, both CFOs and audit committee members are uniquely positioned to assess the value of audit. Financial analysts are skilled and sophisticated users of financial information. They were selected as the target population because they are among the primary users of financial statements, and are generally viewed as important information intermediaries in capital markets, who gather, process, analyze and interpret financial information for investors. Both regulators and other market participants view analysts' activities as enhancing the informational efficiency of security prices, and prior research shows that analysts' activities affect share prices (e.g., Frankel, Kothari, and Weber 2006; Asquith, Mikhail, and Au 2005).

1.3 Approach

To address the research questions, we conducted semi-structured interviews with 30 CFOs and audit committee members of publicly listed companies in Belgium, France, Germany, the Netherlands and the United Kingdom. In addition, we surveyed a representative sample of 171 financial analysts who follow publicly listed companies in Germany, the Netherlands and the United Kingdom. Interviews are particularly useful for getting the story behind participant's opinions, knowledge and experience. Being a far more personal form of research than questionnaires, the interviews allow us to obtain in-depth information from CFOs and audit committee members. The survey design attempts to maximize the generalizability with respect to the population of analysts. A unique feature of our survey is that it tailors the questions to a real public company that an analyst is known to be familiar with from his or her research activities. For a more detailed description of the research methods used and the limitations of the study we refer to the Appendix.

1.4 Timing and motivation of the study

At the time of conducting the interviews for this study (June and July 2009), and also when carrying out the survey of financial analysts in the UK (May and June 2009), poor global economic conditions continued to dominate news headlines. A problem that began in a relatively obscure sector of the US housing market had extended into a widespread credit and liquidity crisis, leading to significant economic downturn that poses a serious threat to economies worldwide.

Unlike the corporate financial reporting scandals earlier this decade, auditors have received comparatively little direct blame for the credit crisis. Nevertheless, against the backdrop of the current financial crisis, questions start to arise about the role of the auditor and value of company audits. In an attempt to stimulate the debate, Sikka (2009) for example notes that many banks collapsed, or had to be bailed out, within a short period of receiving an unqualified opinion, thereby alleging that auditors did not raise concerns that anything was about to go wrong, and also that markets have not been assured by unqualified opinions. The Association of Chartered Certified Accountants (ACCA 2009) interprets Sikka's remarks as signs of unease about the current value of audit. In order to make informed policy recommendations to governments, policy makers and standard setters, as well as the accounting and finance profession as a whole, they call for international research that examines the role of audit, the current level of satisfaction with audits, and the extent to which users of accounts still rely on the assurance given in audit reports when making decisions. In this respect, the findings presented in this study are particularly timely.

It should be stressed upfront that the perceived value of audit in today's capital markets is likely conditional on the perceived value of the current financial reporting system and accounting standards. A report from the CEOs of the international audit networks from early 2008 (BDO International, Deloitte, Ernst & Young, Grant Thornton International, KPMG and PricewaterhouseCoopers 2008) already pointed out that virtually all stakeholders feel that it is necessary to evolve the business reporting model. They recognize that while financial reporting may meet the current standards, it sometimes does not provide the actual information needed to understand what is happening within a company. Nevertheless, even though stakeholders acknowledged the desire to evolve the current financial reporting system, little clarity existed around basic questions regarding what a new business reporting model would look like. For this reason, we take the current financial reporting system as the starting point.

1.5 Outline

The remainder of this report is organized as follows. Chapter 2 presents the findings of our interviews with CFOs and audit committee members. The chapter focuses on key and potentially different expectations of the audit of the financial statements, the overall perceived usefulness of audit, and the perceived usefulness of communications with the auditor in the various stages of the audit process. Chapter 3 details the results of our survey of financial analysts. It examines, amongst other things, to what extent an independent audit of the annual financial statements currently contributes to analysts' confidence in the reliability of annual and interim financial statements. In addition, the chapter investigates to what extent analysts agree that the statutory auditor currently adds value in a number of important areas. Chapter 4 summarizes our conclusions.

Chapter 2:

Interviews with CFOs and audit committee members

2.1 Introduction

The objective of the study presented in this chapter is to examine the perceived benefits and perceived importance of the external audit from the perspective of preparers of financial statements and those charged with oversight of financial reporting and disclosure. For this purpose, we conducted semi-structured interviews with 18 CFOs and 12 audit committee members of listed companies in Belgium, France, Germany, The Netherlands and the United Kingdom. In the interviews we focused on:

- key (and potentially different) expectations of the audit of the financial statements from the perspective of CFOs and audit committee members;
- the overall perceived usefulness of audit by CFOs and audit committee members and the overall role of the auditor;
- the perceived usefulness of communications with the auditor in the various stages of the audit process; and
- the perceived usefulness of working with the auditor, e.g., to facilitate the adoption of appropriate accounting policies, the application of accounting standards and resolving disclosure questions and issues.

CFOs were selected as they are the primary representatives of preparers of financial statements. Audit committee members can be regarded as one of the primary groups charged with oversight of financial reporting and disclosure, and for this task they rely in part on the work of the external auditor (Beasley, Carcello, Hermanson and Neal 2009). Because of their function, both CFOs and audit committee members are uniquely positioned to assess the value of audit as they are directly involved in the financial reporting process and are financially literate.

Previous research examining CFOs perceptions as to the value of the audit have done so mainly by means of surveys (see Hussey and Lan 2001; Iyer and Rama 2004; Gibbins, McCracken and Salterio 2005; Knechel, Wallage, Eilifsen and van Praag 2006; Gibbins, McCracken and Salterio 2007; and Daugherty and Tervo 2008). Only a couple of studies have conducted interviews with these officers (e.g., Hellman 2006; Richard 2006; and McCracken, Salterio and Gibbins 2008). The interview studies have mainly focused on factors increasing the auditor's competence (e.g., industry expertise), auditor client negotiations and the usefulness of an audit to the CFO. The surveys emphasized broader issues such as the roles and responsibilities of auditors regarding independence (Hussey and Lan 2001), desirable attributes of assurance providers (Knechel, Wallage, Eilifsen, and van Praag 2006), the effect of an auditor change on client satisfaction (Daugherty and Tervo 2008), and several issues related to auditor-client negotiations (Iyer and Rama 2004; Gibbins, McCracken and Salterio 2005; and Gibbins, McCracken and Salterio 2007). Overall these prior studies suggest that the CFO appreciates the auditor's competence and expertise.

Recent research shows that audit committees do not consider their role to be merely ceremonial but take their oversight task seriously and rely in part on the work of the external auditor for effective financial reporting monitoring (Beasley, Carcello, Hermanson and Neal 2009). Previous studies on audit committee members' perceptions of the value of the audit have mainly examined issues related to auditor changes (Carcello and Neal 2003; Lee, Mande and Ortman 2004), auditor industry specialization (Abbott and Parker 2000; Chen, Moroney and Houghton 2005), and audit committee support for the auditor in disputes with management (DeZoort and Salterio 2001; DeZoort, Hermanson and Houston 2003a; DeZoort, Hermanson

and Houston 2003b). Most of these studies have conducted experiments or have used archival data to investigate these issues. No studies have been conducted, however, that use interviews to study the perceptions of audit committee members on the value of audit.

This study contributes to the literature in three ways. First, we investigate the perceptions of CFOs and audit committee members on a number of key aspects of the audit process, such as the perceived usefulness of communications with the auditor in the various stages of the audit process, and working with the auditor to facilitate for example the adoption of appropriate accounting policies, the application of accounting standards and the resolution of disclosure questions and issues. Second, by conducting interviews with CFOs and audit committee members, we are able to obtain a more comprehensive view on their perceptions regarding the value of audit. Third, as most of the previous studies have been conducted several years ago, certainly before the start of the current credit crisis, this study provides recent insight in the value of audit after the emergence of the credit crisis. As discussed earlier, the results of our study can help to inform the public debate on the value of audit.

The remainder of this chapter is organized as follows. Section 2.2 presents the results of the study. Section 2.3 provides the summary and conclusions. The appendix provides more details on the research methodology.

2.2 Results

The results are presented in five separate sections. The section hereafter presents the respondents' key expectations of the financial statements audit. Section 2.2.2 describes the usefulness of the audit and the overall role of the auditor. Subsequently, section 2.2.3 discusses the communication with the auditor, and section 2.2.4 provides the respondents' view on the role of the auditor in the financial reporting process. Finally, section 2.2.5 presents any other findings.

2.2.1 Respondents' key expectations of the audit of the financial statements

When asked for their key expectations of the audit of the financial statements, all respondents indicated that one of their key expectations is the formal attestation of the financial statements. The independent check by an external auditor is regarded as an essential part in the financial reporting process. Furthermore, 72% of the CFOs expect the external audit to provide an incentive to their company's subsidiaries and departments to maintain accurate financial records and produce reliable financial statements. They indicate that the financial statements audit provides them with assurance that the company's own internal accounting staff functions properly and produces reliable information. Some CFOs also mentioned that they expect the audit to provide comfort on issues that may not be material to the overall group but which are informative about the company's overall operations. In contrast, several CFOs, especially those of the very large companies, explicitly indicated that their accounting staff is so knowledgeable and advanced that they do not regard the auditor as an additional source of comfort. Another key expectation of the CFOs (61%) is that the auditor acts as a sounding board on critical and complex issues such as IFRS and that he or she challenges the accounting choices made by the company. Other expectations of CFOs are a global presence of their audit firm to ensure the uniform application of standards and a uniform level of quality check (22%), ongoing update of financial developments (17%) and benchmarking against other companies in their industry (11%). The audit committee members indicate that the evaluation of the reliability of the internal control system is an important expectation of the audit (83%). In this respect, we note that there appears to be an expectation gap with respect to internal control, as the international standards on auditing do not require the auditor to evaluate the reliability of the internal control system, except to understand the control environment sufficiently to assess risk and design the appropriate audit response. Similarly, respondents would like the audit to provide insights on the company's risk management system (67%). Furthermore, providing a holistic view of the business is regarded as valuable (33%). Although the respondents understand that it is currently

not the responsibility of the auditor to provide such views, they would welcome a broader, more holistic view of the company. These findings point to a demand for the audit model to be reconsidered, to incorporate additional features, given an appropriate legal and regulatory environment. Finally, directing audit work to increase the likelihood of the identification of fraud (25%) and providing assurance on the absence of material misstatements in the financial statements arising from non-compliance with laws and regulations (17%) are seen as important expectations of the audit.

Overall, the respondents indicated that the auditors currently meet their key expectations. They perceive, however, in part due to the constraints of the current audit model, room for improvement in some areas, particularly internal control, fraud, and risk management. Some respondents stated that they would welcome more insights on internal control and fraud, and the auditor could report more critically in these areas. Global auditing standards do not require auditors to report on fraud, but local requirements differ in this area. As one respondent indicated, for a specific jurisdiction where fraud reporting is required: “Auditors are too much form driven. They have to report on fraud, but there is little substance behind it”. Another common view is that the audit should deliver more than just an approach driven by compliance with auditing standards. As one respondent stated: “It is perhaps driven by legal challenges, but a more ‘idiosyncratic’ approach and less routine processing might produce a better end result in terms of value for the shareholders.” Although the respondents understand that a certain amount of detailed and substantive testing is necessary to reach sound audit judgements, they particularly appreciate the auditor’s ability to stand back from the detail and provide a comprehensive view of their organization.

2.2.2 Usefulness of the audit and the overall role of the auditor

When looking at the usefulness of the audit, both CFOs and audit committee members regard the auditor as a useful source of knowledge, an expert on accounting issues, and a second pair of eyes through auditing the accounts of the business. According to CFOs and audit committee members the audit provides the company and its shareholders with an independent check that gives them assurance on the reliability of the financial statements. In addition, they also regard the audit as fulfilling a statutory requirement. One CFO noted as follows: “Although investors would tell you that the audit is a basic necessity and that they merely glance over the audit opinion, they would most certainly be worried if it were missing.”

An interesting observation is, however, that CFOs especially indicate a decreasing usefulness of financial statements and, related to that, of the financial statements’ audit. Mainly because of the many changes in financial reporting regulation and the complex nature of IFRS, it is argued that investors do not understand the financial accounts anymore. A common remark was that the more complicated accounts become, the less utility they have for the users. For example, one CFO noted: “There is a drift apart between the numbers we report under IFRS and the numbers that are useful for investors and reflect the actual position of the firm.” Several respondents indicated that this also calls for a different role of the auditor. One respondent expressed this as follows: “You envision a different role for the auditor. The current system doesn’t serve the users in the best manner. If you look at the users, the product hasn’t got utility, and therefore there is a significant on-cost that companies bear – internally and through the payment of the audit fee - and therefore you question the utility of the final process. A good process would be to completely reverse this. One should start from the premise whether the business is being run in the right direction and by the right people.” In effect, this view echoes the call to reassess the traditional audit reporting model. In addition to providing insights on a company’s financial performance, investors and other stakeholders want insights on a company’s business model, its key risks, and the relationships to which a business is exposed, as well as into matters of governance, including remuneration models, leadership styles, and tone from the top. If such information is currently reported by a company, auditors ensure that it is not materially inconsistent with information of which they are aware. However, they are not required to audit this information or to make further enquiries of management or those charged with governance

in respect of it. Social expectations of companies are changing too. Concerns about labour conditions, global warming, and conserving the planets limited resources for future generations translate in the need for companies to be accountable on such matters. Creating an integrated reporting model that can accommodate these developments obviously poses great challenges to the accounting and auditing profession.

A further issue concerns the corrective versus the preventative role of the auditor. The external auditor can have a corrective role by detecting errors and making adjustments in the financial statements, and a preventative role as the audit provides an incentive encouraging the client to produce reliable financial statements. Most respondents (97%) felt that the auditor performs a corrective role. However, both CFOs and audit committee members also indicated that in practice, in large, well-managed businesses, there tend to be less accounting errors and hence the corrective role is considered less important than the preventative role. Nevertheless, most participants echoed the view that the corrective role remains important even in this environment, as it leads to overall improvement. One participant noted: "There is a permanent feedback loop: the outside world wants assurance, and the inside world wants improvement, and through the corrective role, these improvements ultimately lead to more assurance." Although most respondents (90%) felt that the auditor also performs a preventative role, there was variation in responses: 100% of audit committee members considered the preventative role of the auditor to be important compared with 83% of the CFOs who did so. In general, the CFOs perceive the preventative role as less important since, because of their detailed knowledge of the control system, they believe that there is a good control environment and control awareness in their company. For example, one CFO commented: "I like to think that we already have the right mindset to produce reliable financial statements." Nevertheless, they do perceive the preventative role as important as it is considered helpful in providing a further incentive to seek to eliminate errors in financial information throughout the organization.

In general, the audit committee members attach more value to the preventative role of audit than CFOs do. According to the audit committee members, bringing to bear a "second pair of eyes" helps to encourage the openness of management, as the audit provides an additional incentive to produce reliable financial statements.

2.2.3 Communication with the auditor

A next issue is the perceived usefulness of communications with the auditor in the various stages of the audit process. Overall the communication with the auditor is regarded as useful. On the question of the extent of the usefulness of the communication and interaction with the auditor, all respondents indicated that this is 'useful' to 'very useful'. This applies to the communication during the audit and the communication of the audit findings. The respondents particularly value the open dialogue and indicate that they are satisfied with the timeliness and frequency of the communication. One CFO noted: "We have a very good open dialogue between the group audit team and the CFO and the controller. Once they start the year-end fieldwork, we have weekly meetings to review what they come up with either in the UK or overseas. I think it is very useful to have that open channel of communication." Respondents also agreed that their auditor is always available on an ad-hoc basis.

Furthermore, the respondents value the presentation of the audit findings. Most respondents (77%) indicate that a good discussion on the key findings is useful. Some respondents added here that the focus should be on the key issues, and that the auditor should not in general present minor issues. Most respondents perceive a tendency towards a more clear and useful way of communication of audit findings. One CFO noted: "The auditor has made efforts recently to present the audit findings in a helpful way, summarize them at the high level and going down into more detail, and similarly trying to identify improvements."

The parts of the management letter that CFOs consider valuable mainly concern matters related to internal control over financial reporting, including general suggestions to improve internal

control over financial reporting or any deficiencies in internal control that could adversely affect the client's ability to generate accurate and reliable accounting information (94%; average score of 4.6 on a scale of 1-5); and the audit findings (detected and adjusted errors, accounting issues, estimates) and proposed adjustments by the auditor (78%; average score of 4.3). 22% of the CFOs indicated that suggestions to management that are meant to enable the company to improve business performance in some way would be valuable (average score of 2.5). However, most CFOs recognise this is not currently part of the auditor's role. Other matters that CFOs consider important or useful in the auditor's management letter are IT security issues (33%; average score of 4.0) and insights on the companies' risk management systems (28%; average score of 3.9).

When considering the communication between the auditor and the audit committee in more detail, the audit committee members are all very satisfied with the auditor's communication of the audit findings (average score of 4.8 on a scale of 1-5). The focus on only key material issues is well-appreciated. They would nevertheless also appreciate more extensive insights from the auditor on the risk management system of the company and a broader, more holistic view on the business. In relation to this, one audit committee member indicated that he would like the auditor to take "a 30.000 foot view" of the company. It is noted, however, that this goes beyond the current remit of auditors, and hence raises the question of whether the audit function should be reassessed, as mentioned previously.

Furthermore, the parts of the management letter that audit committee members perceive to be most important are (1) matters related to internal control over financial reporting (average score of 4.3 on a scale of 1-5), (2) the nature and resolution of significant adjustments found during the audit, including immaterial differences that were not corrected by management (average score of 4.2), (3) major issues discussed with management prior to being retained for the engagement (average score of 4.2) and (4) the acceptability and/or quality of accounting choices (average score of 4.1), and (5) the nature and resolution of disagreement with management concerning accounting issues and estimates (average score of 3.9).

Besides these overall positive views of the respondents on communication with the auditor, a couple of critical remarks were made, suggesting that there is room for improvement. Some respondents indicate that the management letters become thinner every year and discussions more formal. As an example, one CFO mentioned: "The real discussion about the business and the findings on the business is limited, while this really adds value."

Another issue mentioned several times by the CFOs is the communication between the audit engagement partner and the audit firm's technical office. Especially on complex issues, the engagement partner often offers an initial view to the client, which he then seeks to consult upon with the technical office in order to have an informed debate with the CFO. Although the CFOs acknowledge that such consultation is necessary, and enhances the value of the judgement, they sometimes perceive this initial view as final, and are unaware that consultation still needs to take place. Particularly in those instances where the consultation with the technical office leads to a different insight, CFOs perceive the communication by the audit firm to be unclear. On the other hand, there is also much appreciation for the firms' technical knowledge on reporting issues, as we will see in the next section.

2.2.4 The role of the auditor in the financial reporting process

This section will discuss the perceived usefulness of working with the auditor to facilitate the adoption of appropriate accounting policies, the application of accounting standards and the resolution of disclosure questions and issues. Respondents predominantly (80%) find it useful to very useful to work with the auditor on financial reporting matters. Audit committee members value this role of the auditor slightly more than CFOs do (83% versus 76%), but for both groups the majority clearly values this role of the auditor. The CFOs that indicate that they find it 'useful' or 'very useful' to work with the auditor on financial reporting matters predominantly

appreciate the knowledge that the auditor brings to the table. Knowledge on more technical and complex areas of IFRS is particularly highly valued. As one CFO mentioned, “As we are going through the final preparation of the financial accounts, the auditors are a very useful source of knowledge. We like to think that our team has a good understanding of IFRS, but it’s a constantly changing picture and we would look to the auditors to have the very up-to-date latest view and also the ability to compare to what other clients are doing.” Although most companies have their own IFRS specialist, they want the auditor to check and challenge their views. The auditor then serves as an independent expert on the accounting choices made.

Also, CFOs value the worldwide presence of the audit firms, especially regarding their knowledge on financial accounting rules in various countries. As several CFOs noted, however, the downside of this is that the knowledge and the quality of the local auditors can differ from country to country, mainly depending on the stage of development of the accounting profession within a country. In the area of IFRS, for example, some respondents indicated that the interpretation of IFRS is different in developing countries, and therefore suggest that the accounting profession needs to make sure that standards are applied universally.

Those respondents that perceive working with the auditor to facilitate the adoption of appropriate accounting policies, the application of accounting standards and the resolution of disclosure questions and issues to be less useful (20%), mainly indicate that they have sufficient in-house expertise, such as IFRS specialists, consolidation experts, an internal audit department, and a well-equipped accounting department. Therefore, they have less need for the technical expertise of the auditor. This of course particularly applies to larger companies as they are more likely to have in-house expertise.

2.2.5 Other findings

Finally, the interviews provided some other interesting findings on the value of the audit. Two-thirds of the audit committee members believe that the auditor has helped in dealing with the consequences of the current financial crisis for their financial statements. They particularly appreciate the role of auditors challenging management in: assessing impairments; identifying future business trends; and accounting choices and judgements made. In addition, 44% of the CFOs indicate that the auditor has been helpful in dealing with the consequences of the financial crisis on their company’s reporting. Most CFOs mention that they themselves are very proactive and in control on these matters, but acknowledge that the consequences of the financial crisis will become more prevalent in the upcoming financial statements, and that auditors will continue to add value through their role in questioning impairments, fair value estimations, the evaluation of financial instruments, and so on.

A further issue relates to the cooperation between internal audit departments or operational audit departments and the external auditor. Several CFOs and audit committee members echoed the view that there is added value to be created for both the auditor and the auditee when there is more cooperation between internal audit departments or operational audit departments and the external auditor. As one audit committee member stated: “There is willingness but some audit firms have better cooperation than other. In those cases where there is more cooperation, the auditor is able to deliver more value, and management is more convinced of the additional value delivered by the auditors. The auditor should therefore develop best practices on the cooperation with internal audit departments.” We note, however, that such cooperation should be critically assessed as it could compromise the perceived independence of auditors.

To conclude, we asked respondents to give an overall grade on the value of audit. The overall grade on a scale from 1 to 10, where 1 = no value and 10 = excellent value, is 7.3, and 86% of the participants awarded a grade of 7.0 or higher. The average grade that the CFOs gave is 7.2 and that of the audit committee members is 7.5. Therefore, the overall conclusion is that the CFOs and audit committee members perceive the value of the audit and the auditor as positive and that the auditor generally meets their expectations.

2.3 Summary and conclusions

This chapter reports the findings of a study on CFOs' and audit committee members' perceptions on the benefits and importance of the external audit. To this end, we conducted semi-structured interviews with 18 CFOs and 12 audit committee members of listed companies in Belgium, France, Germany, the Netherlands and the United Kingdom. In our interviews we focused on key expectations of the audit, the perceived usefulness of the audit and the overall role of the auditor, the perceived usefulness of communications with the auditor in the audit process, and the perceived usefulness of working with the auditor on financial reporting issues. Our main results are as follows.

First, besides the formal attestation of the financial statements, key additional features that an auditor is well-placed to provide are: providing an additional incentive to company's subsidiaries and departments to maintain accurate financial records and produce reliable financial statements; acting as a sounding board on critical and complex issues; evaluating the reliability of the internal control system (as appropriate, either as part of the audit in certain jurisdictions, or as an additional engagement in others); providing insights on the companies' risk management system, and offering a broader, more holistic view of the business. In general, the key expectations of respondents are met, but there is clearly a demand for further features in addition to the current audit remit. To this end, the current audit model merits reassessment, to go beyond the existing remit and adopt a more comprehensive approach to provide the desired holistic view, given the appropriate legal and regulatory environment. We note that these results point to the presence of an expectation gap in particular with regard to internal control as the international standards on auditing do not require auditors to formally consider or attest to the reliability of the internal control system, except for gaining an understanding of the control environment necessary to design an appropriate audit response. Naturally, such consideration or attestation can be provided as a separate engagement, where it is not a jurisdictional requirement.

Second, both CFOs and audit committee members consider the auditor to be a useful source of knowledge, an expert on accounting issues, and a "second pair of eyes" through auditing the accounts of the business. However, the CFOs in particular observe a decrease in the usefulness of the financial statements, and by consequence the audit. According to them, investors have trouble understanding financial statements due to the myriad of changes in financial reporting regulation (including IFRS). To ensure that the audit is not just a compliance approach driven by a checklist, they envision an enhanced role for the auditor as a sounding board on critical and complex issues and for the vast majority of businesses consider the auditor's corrective role to be more important than the auditor's preventative role.

Third, all respondents indicate that they consider the communication with the auditor to be useful, and are particularly satisfied with the open dialogue, the timeliness and frequency of communication, and the tendency towards more transparent communication. With respect to the management letter, CFOs appreciate those parts that relate to internal control over financial reporting, audit findings and proposed adjustments, IT security issues, and insights on the company's risk management system. Audit committee members are also very satisfied with the auditor's communication of the audit findings and appreciate the auditor's focus on material issues. However, they would also welcome more insights on the company's risk management system. Nevertheless, some respondents also see room for improvement in certain areas, as they find that management letters become thinner every year and discussions more formal but less informative. Also in their communication with the audit engagement partner especially with regard to complex financial reporting issues where consultation with the audit firm's technical office takes place, CFOs would appreciate better communication around the final position of the audit firm on a particular technical matter.

Fourth, respondents generally appreciate dialogue with the auditor on financial reporting issues. Although most companies have their own IFRS specialist, the auditor's knowledge of complex IFRS issues is particularly highly valued. CFOs also value the audit firms' worldwide presence, and with that the firms' knowledge on financial accounting rules in various countries. However, they also note that the local auditors' knowledge and quality can differ from country to country, and it seems that audit firms can improve universal application of accounting standards.

Fifth, the majority of the audit committee members find that the auditors' input with respect to challenges to management around judgements on impairments, identification of future business trends, and accounting choices made helps in the aftermath of the financial crisis. Another matter relates to cooperation between internal (or operational) audit departments and the external auditor. According to the respondents added value can be created for both the auditor and the auditee when there is increased cooperation between the two. This should be approached with care however, since it could compromise the perceived independence of auditors. Finally, on a scale from 1 to 10, where 1 = no value and 10 = excellent value, the respondents' overall grade for the value of audit is 7.3.

Chapter 3: Survey of financial analysts

3.1 Introduction

The aim of the study presented in this chapter is to examine sell-side analysts' perceptions of the value of an audit of the financial statements. Sell-side analysts are skilled and sophisticated users of financial information. They were selected as the target population because they are among the primary users of financial statements, and are generally viewed as important information intermediaries in capital markets, who gather, process, analyze and interpret financial information for investors.¹ Both regulators and other market participants view analysts' activities as enhancing the informational efficiency of security prices (Frankel, Kothari, and Weber 2006). Prior research shows that analysts' stock recommendations, price targets, earnings forecasts, and written reports affect share prices (e.g., Barber, Lehavy, McNichols, and Trueman 2001; Brav and Lehavy 2003; Asquith, Mikhail, and Au 2005).

Because information from financial statements serves as an important input in analysts' forecasting and valuation models (e.g., Barker and Imam 2008), it is important that analysts can rely on these statements. Traditionally, auditors are uniquely positioned to provide services that improve the reliability of financial statements. There is, however, little direct evidence in the academic literature on the extent to which the perceived reliability of financial statements, and the perceived overall reliance on these statements by analysts, is influenced by the fact that these statements are independently audited. Several prior studies provide insight in analysts' perceptions of various audit-related issues, such as auditor industry specialization (Dunn and Mayhew 2004; Payne 2008), auditor tenure (Ghosh and Moon 2005), provision of nonaudit services (Swanger and Chewning 2001; Brandon, Crabtree and Maher 2004), and the usefulness of the auditor's opinion (Duréndez Gómez-Guillamón 2003; O'Reilly, Leitch and Tuttle 2006; and Ghicas, Papadaki, Siougle, and Sougiannis 2008). However, there is little direct evidence of analysts' perceptions of the value of the audit as such.

The study reported in the current chapter aims to fill this gap and contributes to the extant literature in two ways. First, by examining to what extent an independent audit of the annual financial statements currently contributes to: (a) analysts' confidence that the annual financial statements fully comply with applicable accounting standards; (b) analysts' confidence that the annual financial statements are free from unintentional material misstatements; (c) analysts' confidence that the annual financial statements are free from intentional material misstatements; and (d) analysts' perceived overall reliance on the annual financial statements when analyzing companies' equity value. Second, we assess whether analysts perceive that the reliability of interim financial statements improves when auditors review these statements. We also examine if an independent audit of the interim financial statements further increases the perceived reliance on these statements. In addition, we examine to what extent analysts agree that the statutory auditor currently adds value by: (a) assuring that a company complies with applicable accounting and disclosure regulations; (b) questioning the company's internal control processes and systems; (c) making the company aware of the financial reporting risks to which the company is exposed; (d) improving companies' financial reporting and disclosure decisions; (e) providing a disincentive for the commission of fraud by managers and employees; and (f) improving access to capital and lowering companies' cost of both debt and equity capital.

To obtain analysts' opinions we use a survey approach. The analysts targeted cover publicly listed companies in the Netherlands, Germany and the United Kingdom. To increase realism for the analysts of the context in which their opinions are elicited, we tailor the questions to a real public company that the analysts are known to be very familiar with from their research activities.

The remainder of this chapter is organized as follows. Section 3.2 briefly describes the outline of the questionnaire. Section 3.3 presents the results of the study. Section 3.4 summarizes and concludes. The appendix provides more information on the research methodology.

3.2 Questionnaire

The web-based questionnaire consists of an introduction, four main parts, and some background questions. The four main parts are about a randomly selected publicly listed company that a particular analyst is familiar with from his or her research activities. The name of this company is mentioned explicitly in each of the parts, which are further described below.

Part 1 of the questionnaire starts by explaining that the most recent annual financial statements of the selected company that the analyst is covering have been audited by a particular audit firm. The name of the company's current audit firm is specified here. We also indicate that the notes to the financial statements tell that they have been prepared in accordance with a particular set of accounting standards (usually International Financial Reporting Standards). Next, we pose three questions designed to elicit analysts' confidence that the most recent annual financial statements of the company that they cover: (a) comply with applicable accounting standards; (b) are free from material unintentional misstatements or omissions; and (c) are free from material intentional misstatements or omissions. Analysts were asked to indicate their confidence on a seven-point scale (1 = not at all confident; 7 = very confident). The meaning of the term "material" is clarified when an analyst moves the mouse pointer over this term. A fourth question elicits analysts' overall perceived reliance on the most recent financial statements of the company that they are covering when analyzing the company's equity value. Analysts were asked to indicate their overall reliance on a seven-point scale (1 = no reliance; 7 = intense reliance).

Part 2 of the questionnaire asks the analysts to consider a hypothetical scenario. We explicitly mention that all characteristics of the covered company, except those mentioned under the hypothetical scenario, must be assumed to remain the same. The hypothetical scenario states that the laws and regulations in the company's home country do not require companies to have their annual financial statements audited by an independent qualified auditor. It further states that companies can voluntarily choose to hire an independent qualified auditor, but that the company that is covered by the analyst has chosen to rely on the effectiveness of its internal control system and internal audits. It is also stated that the company's most recent annual financial statements have therefore not been audited and will not be audited in the near future. For this hypothetical scenario, we then ask again the same four questions as posed in Part 1: three questions to elicit analysts' confidence in the annual financial statements, and one question to elicit analysts' overall perceived reliance on the annual financial statements of the company that they cover.

Part 3 of the questionnaire starts by mentioning that the company that the analyst covers also publishes interim financial statements, and that these statements are typically not audited, but that they may be reviewed by the company's statutory auditor. The difference between an independent review and an independent audit is briefly clarified. Next, we confront the analysts with two statements designed to elicit their opinions on whether the reliability of the financial information in the interim financial statements of the covered company improves when an auditor reviews these statements, and if an independent audit instead of a review of interim financial statements would further increase their perceived overall reliance on interim financial statements of the company. Analysts were asked to indicate their agreement with the two statements on a seven-point scale (1 = strongly disagree; 7 = strongly agree).

Part 4 confronts the analysts with seven statements designed to elicit their opinions on the added value of the work of the company's statutory auditor, including achieving compliance with applicable

accounting and disclosure regulations, questioning the company's internal controls, increasing the company's awareness of financial reporting risks, improving the company's financial reporting and disclosure decisions, preventing fraud by the company's managers and employees, improving the company's access to equity capital and lowering the company's cost of equity, and improving the company's access to debt capital and lowering the company's cost of debt. Analysts were again asked to indicate their agreement with each statement on a seven-point scale (1 = strongly disagree; 7 = strongly agree).

The last page of the questionnaire includes four questions on analysts' professional experience and qualifications. The respondents' median (mean) experience in equity research is 8 (10) years. Their minimum experience in equity research is one year, and the maximum is 40 years. The median (mean) experience in researching the selected company is 3 (4) years, with a minimum of half a year, and a maximum of 34 years. The median (mean) experience in researching companies in the selected company's industry subsector is 5 (7) years, with a minimum of half a year and a maximum of 34 years. Of all respondents, 59 percent has a professional degree, or holds a professional charter in financial analysis (such as the Chartered Financial Analyst charter). Taken together, the respondents' level of experience and qualifications strongly suggests that they can provide meaningful assessments of the value of audit for the selected companies that they cover.

3.3 Results

3.3.1 Respondents' confidence in and perceived reliance on annual financial statements

Table 3.1 presents the results for Part 1 of the questionnaire.^{II} What we can clearly conclude from these results is that the respondents, overall, do have confidence that the annual financial statements of the company that they cover fully comply with applicable accounting standards. In addition, we can conclude that respondents have confidence that the annual financial statements are free from material misstatements, both intentional and unintentional. Interestingly, respondents have more confidence that the financial statements are free from material intentional misstatements than from material unintentional misstatements.^{III} Finally, respondents generally rely on the annual financial statements when analyzing a company's equity value.

Table 3.1

Respondents' confidence in and perceived reliance on annual financial statements (N = 171)

	Median	IR	Mean	SD	<4	>4
(a) Confidence that the company's most recent annual financial statements comply with applicable accounting standards	6	5-7	5.8	1.2	5%	89%
(b) Confidence that the company's most recent annual financial statements are free from material unintentional misstatements or omissions	5	5-6	5.2	1.3	9%	76%
(c) Confidence that the company's most recent annual financial statements are free from material intentional misstatements or omissions	6	5-7	5.8	1.3	7%	88%
(d) Overall reliance on the company's most recent financial statements when analyzing the company's equity value	5	4-6	5.2	1.4	13%	74%

Responses for confidence and reliance are based on a seven-point scale:

1 = Not at all confident, 7 = Very confident

1 = No reliance, 7 = Intense reliance

3.3.2 Respondents' confidence in and perceived reliance on annual financial statements: Audited versus non-audited annual financial statements

To test whether analysts generally perceive that an independent audit of the annual financial statements is important, we examine to what extent respondents have more confidence in the reliability of the annual financial statements of the company that they cover in the situation that these statements are audited (the actual situation) compared to a situation in which the statements are not audited (a hypothetical scenario).

Table 3.2 presents the results of our examination: a within-subject comparison of responses when these statements are (i) audited by the company's current audit firm, and (ii) not subject to an audit. The results for each item are briefly discussed below.

Item (a): In the situation that the annual financial statements are not audited, respondents lack confidence that the company's most recent annual financial statements comply with applicable accounting standards. Compared to the situation in which the statements are audited, the median level of confidence halves from 6 to 3. Also, much more respondents assign a score below four (48 percentage points difference), and much less respondents assign a score above four (65 percentage points difference). Wilcoxon signed-rank tests show that the difference in scores is strongly statistically significant [$p=0.000$; two-sided].

Item (b) and (c): In the situation that the annual financial statements are not audited, respondents lack confidence that the company's annual financial statements are free from material misstatements or omissions. Compared to the situation in which the statements are audited, the median level of confidence that unintentional material misstatements are absent, decreases from 5 to 3. Much more respondents assign a score below four (54 percentage points difference), and much less respondents assign a score above four (59 percentage points difference). The median level of confidence that intentional material misstatements are absent even halves from 6 to 3. Much more respondents assign a score below four (47 percentage points difference), and much less respondents assign a score above four (59 percentage points difference). Wilcoxon signed-rank tests show that the difference in scores is strongly statistically significant [$p=0.000$; two-sided].

Item (d): In the situation that the annual financial statements are not audited, respondents generally indicate that they do not rely on the annual financial statements. Compared to the situation in which the statements are audited, the median level of reliance decreases from 5 to 3. Much more respondents assign a score below four (44 percentage points difference), and much less respondents assign a score above four (52 percentage points difference). Wilcoxon signed-rank tests show that the difference in scores is strongly statistically significant [$p=0.000$; two-sided].

To further quantify the overall difference in responses on the four items, we add up, per situation, the scores on each item, resulting in two summated scales that give equal weight to each item.^{IV} As can be seen in Table 3.2, the median (mean) difference between the scores of the two summated scales is 8 (8.8) points. This corresponds to a drop in the median (mean) score of 35% (40%) when moving from a situation in which the statements are audited to a situation in which the statements are not subject to audit. Wilcoxon signed-rank show that the difference is strongly statistically significant [$p=0.000$; two-sided].

In summary, we find evidence for a relatively large and statistically significant increase in confidence and reliance when the annual financial statements are audited, compared to a situation in which the statements are not audited. This suggests that the responding analysts generally perceive that the auditor's work is valuable to them by increasing their confidence in, and reliance on, the annual financial statements.

Table 3.2
 Respondents' confidence in and perceived reliance on annual financial statements:
 Audited versus non-audited annual financial statements (N = 171)

		Median	IR	Mean	SD	<4	>4
(a) Confidence that the company's most recent annual financial statements comply with applicable accounting standards	(i) Audited	6	5-7	5.8	1.2	5%	89%
	(ii) Not audited	3	2-4	3.4	1.5	53%	24%
	Difference	3	1-3	2.4	1.6		
(b) Confidence that the company's most recent annual financial statements are free from material unintentional misstatements or omissions	(i) Audited	5	5-6	5.2	1.3	9%	76%
	(ii) Not audited	3	2-4	3.1	1.4	63%	17%
	Difference	2	1-3	2.1	1.7		
(c) Confidence that the company's most recent annual financial statements are free from material intentional misstatements or omissions	(i) Audited	6	5-7	5.8	1.3	7%	88%
	(ii) Not audited	3	2-5	3.4	1.7	54%	29%
	Difference	2	1-4	2.4	1.5		
(d) Overall reliance on the company's most recent financial statements when analyzing the company's equity value	(i) Audited	5	4-6	5.2	1.4	13%	74%
	(ii) Not audited	3	2-4	3.2	1.5	57%	22%
	Difference	2	1-3	1.9	1.5		
(e) Summated scale of items (a) to (d)	Audited	23	20-25	22.0	4.1	NA	NA
	Not audited	13	9-17	13.1	5.1		
	Difference	8	5-12	8.8	5.3		

Responses for confidence and reliance are based on a seven-point scale:

1 = Not at all confident, 7 = Very confident

1 = No reliance, 7 = Intense reliance

3.3.3 Respondents' opinions on an independent review and an independent audit of the interim financial statements

Table 3.3 presents the results for Part 3 of the questionnaire. The median score of 5 indicates that the respondents, overall, agree with the two statements. Besides, no large proportion of respondents holds a contrasting view.

Table 3.3

Respondents' opinions on an independent review and an independent audit of the interim financial statements (N = 171)

	Median	IR	Mean	SD	<4	>4
An independent review of the company's interim financial statements improves the reliability of the financial information included in these statements	5	4-6	5,0	1,3	13%	68%
If the company's interim financial statements would be subject to an independent audit rather than an independent review, my overall reliance on these statements would increase	5	4-6	4,5	1,6	23%	56%

*Responses are based on a seven-point scale:
1 = Strongly disagree, 7 = Strongly agree*

What we conclude from the results is that the respondents, overall, agree that an independent review of the interim financial statements of the company that they cover improves the reliability of the financial information included in these statements. In addition, respondents, overall, agree that an independent audit instead of an independent review further increases their overall reliance on the interim financial statements. The latter finding further strengthens the view that respondents perceive that an audit improves the usefulness of financial statements.

3.3.4 Respondents' opinions on the added value of the statutory auditor

Table 3.4 presents the results for Part 4 of the questionnaire. It summarizes the responses to seven statements that were designed to elicit respondents' opinions on whether the company's statutory auditor adds value in several possible ways. The median scores clearly reveal that respondents, overall, agree that the statutory auditor adds value in each of the areas investigated. Except for respondents' perception on the added value of the auditor in improving companies' access to capital and lowering companies' cost of capital (both debt and equity), no large proportion of analysts holds a contrasting view.

For the two items relating to the added value of the auditor with respect to access to capital and cost of capital, disagreement is more widespread: 25% of the respondents disagrees on the added value in this respect. Closer examination shows that the relatively large proportion of disagreement is mainly due to responses from the UK. As explained in the Appendix, a plausible explanation for the more pessimistic view in the UK on this issue is the fact that responses for the UK were obtained after the sharp reduction in the general availability of capital since the autumn of 2008, while the other responses were obtained earlier.

In summary, we conclude that analysts find that the statutory auditor currently adds value by: (a) assuring that a company complies with applicable accounting and disclosure regulations; (b) questioning the company's internal control processes and systems; (c) making the company aware of the financial reporting risks to which the company is exposed; (d) improving companies' financial reporting and disclosure decisions; (e) providing a disincentive for the commission of fraud by managers and employees; and (f) improving access to capital and lowering companies' cost of capital (both debt and equity).

Table 3.4
Respondents' opinions on the value of the statutory auditor (N = 171)

	Median	IR	Mean	S.D.	<4	>4
The company's statutory auditor adds value by:						
Assuring that the company fully complies with all accounting and disclosure regulations that apply to the company.	6	5-6	5,6	1,1	5%	87%
Questioning the company's internal control processes and systems.	5	4-6	4,7	1,3	16%	55%
Making the company aware of the financial reporting risks to which the company is exposed.	5	5-6	5,2	1,3	9%	76%
Improving the company's financial reporting and disclosure decisions.	5	5-6	5,3	1,3	9%	78%
Preventing fraud by the company's managers and employees.	5	4-6	4,8	1,5	17%	63%
Improving the company's access to debt capital and reducing the company's cost of debt.	5	4-6	4,5	1,6	25%	59%
Improving the company's access to equity capital and reducing the company's cost of equity.	5	4-6	4,5	1,6	25%	57%

Responses are based on a seven-point scale:
1 = Strongly disagree, 7 = Strongly agree

3.4 Summary and conclusions

This chapter reports the findings of a survey of sell-side analysts' perceptions on the value of an audit of the financial statements. Sell-side analysts are among the primary users of financial statements, and are widely viewed as important information intermediaries in capital markets. While information from financial statements serves as an important input in analysts' decision processes, there is, however, little direct evidence in the academic literature on the extent to which analysts' perceived reliability of financial statements, and analysts' perceived reliance on financial statements, is influenced by the fact that these statements are independently audited. The analysts targeted cover publicly listed companies in the Netherlands, Germany and the United Kingdom.

The main results of our survey are fourfold. First, we find that respondents, overall, have confidence that the annual financial statements of the company that they cover fully comply with applicable accounting standards. In addition, they generally have confidence that the annual financial statements are free from material misstatements, both intentional and unintentional. Respondents also generally indicate to rely on the annual financial statements when analyzing a company's equity value.

Second, to test whether analysts generally perceive that an independent audit of the annual financial statements is important, we examine to what extent respondents have more confidence in the reliability of the annual financial statements of the company that they cover in the situation that these statements are audited compared to a situation in which the statements are not audited. We find evidence for an economically large and statistically significant increase in confidence and reliance on annual financial statements when these statements are audited, compared to a situation in which the statements are not audited. This strongly suggests that the responding analysts generally perceive that the auditor's work is valuable to them by increasing their confidence in, and reliance on, the annual financial statements.

Third, respondents, overall, agree that an independent review of the interim financial statements of the company that they cover improves the reliability of the financial information included in these statements. In addition, respondents agree that an independent audit of the company's interim financial statements further increases their overall reliance on these statements. The latter finding further strengthens the view that respondents find that auditing improves the usefulness of financial statements.

Finally, the results show that analysts find that the statutory auditor currently adds value in a number of important areas like compliance, internal control, financial reporting problems, fraud prevention, and access to capital.

Chapter 4: Conclusions

4.1 Introduction

The aim of this chapter is to summarize our conclusions from interviews with CFOs and audit committee members (Chapter 2), and the survey of financial analysts (Chapter 3). We do so by addressing the research questions formulated in the introduction (Chapter 1).

4.2 What is the value of audit as perceived by CFOs and audit committee members?

Based on our interviews with CFOs and audit committee members we conclude that for CFOs the key expectations of the audit are formal attestation of the financial statements, incentivising maintenance of accurate financial records and production of reliable financial statements by the company, and the auditor acting as a sounding board for management. Besides the formal attestation of the financial statements, audit committee members would like the auditor to evaluate the reliability of their company's internal control system, to provide insights on the company's risk management system, and would welcome a holistic view of the business. Especially with respect to this last expectation, our findings raise the question whether the current audit function should be reassessed, as this currently goes beyond the remit of the statutory audit. Although respondents perceive, in part due to the constraints of the current audit model, that there is room for improvement in certain areas, such as internal control, fraud, and risk management, they find that their expectations are generally met. Our findings point to an expectation gap in particular with regard to internal control, as the international standards on auditing do not require the auditor to evaluate the reliability of the internal control system, except to obtain a sufficient understanding of the control environment necessary for developing an appropriate audit plan. Furthermore, we find that CFOs would appreciate the auditor assuming an enhanced role as an independent expert on critical and complex issues in order to ensure that the audit is not driven purely by a compliance approach. Both groups find the auditor's corrective role important; but in general, audit committee members attach more value to the preventative role than CFOs do. We also conclude that all respondents consider the communication with the auditor, both during and after the audit, as useful. They appreciate the open dialogue, the timeliness and frequency of communication, and the increasing transparency of this communication. Although management letters are well-received, several respondents perceive the related discussions to become more formal and less informative. Also, CFOs value clear communications with respect to conclusions on technical issues, after the audit partner has consulted with the audit firm's technical office. As a further conclusion, respondents find dialogue with the auditor on financial reporting issues, in particular complex IFRS issues, to be useful. Audit firms' global presence is believed to contribute to this benefit. CFOs do nevertheless note that auditors should strive for a more universal application of accounting standards. Finally, our results show that (a) most audit committee members indicate that the auditors' input, in terms of their challenge to management, helps in dealing with the consequences of the current financial crisis for their company's reporting; and (b) respondents find that added value can be created for both the auditor and the auditee when there is increased cooperation between the auditee's internal (or operational) audit department and the external auditor. Such increased cooperation should be approached with caution, since it might however lead to a perceived decreased independence of the auditor. Finally, the respondents' award an overall grade of 7.3 out of 10 for the value of the audit. Therefore, we can conclude that our respondents positively perceive the value of the audit and the auditor and find that the auditor meets their expectations.

4.3 What is the value of audit as perceived by financial analysts?

Our conclusions from the survey of financial analysts are that analysts generally perceive that an audit of the annual financial statements currently contributes to their: (a) confidence that the annual financial statements fully comply with applicable accounting standards; (b) confidence that the annual financial statements are free from unintentional material misstatements; (c) confidence that the annual financial statements are free from intentional material misstatements; and (d) perceived overall reliance on the annual financial statements when analyzing companies' equity value. In addition, we conclude that analysts perceive that the reliability of interim financial statements improves when auditors review these statements, and that an independent audit of the interim financial statements instead of a review further increases the perceived reliance on these statements. Finally, we conclude that analysts perceive that the statutory auditor adds value by: (a) assuring that a company complies with applicable accounting and disclosure regulations; (b) questioning companies' internal control processes and systems; (c) making the company aware of the financial reporting risks to which the company is exposed; (d) improving companies' financial reporting and disclosure decisions; (e) providing a disincentive to the commission of fraud by managers and employees; and (f) improving access to capital and lowering companies' cost of both debt and equity capital. The overall conclusion that we draw from the survey of financial analysts is that analysts generally perceive that the auditor's work is valuable to them by increasing their confidence in, and reliance on, financial statements.

Appendix: Research method

This appendix provides an overview of the research methodology used in this study. Part A describes the research design of the study on the interviews with CFOs and audit committee members. Part B describes the research design used for the survey of financial analysts.

Part A: Interviews with CFOs and audit committee members

Research on the perceived benefits and perceived importance of external audit from the perspective of preparers of financial statements and those charged with oversight of financial reporting and disclosure is rather scarce. In order to obtain extensive insight into the perceptions of CFOs and audit committee members on the value of the audit, we decided to conduct semi-structured interviews with them. Compared to the more extensively used survey technique, the greatest value of interviews is the depth of information and detail that can be attained. Compared to surveys, interviewers can immediately respond to interviewees' responses and validate their statements by probing them with additional questions. The interview technique also offers more control than other techniques to ensure that the relevant issues are discussed. The obvious disadvantage of interviews is the fact that they are time-consuming and therefore quite costly. Hence, sample sizes are usually much smaller than those of surveys.

Interviews were conducted with 30 respondents from Belgium, France, Germany, The Netherlands and the United Kingdom, including 18 CFOs^v and 12 audit committee members. The interview was structured around 15 questions identified from four sources: the academic and professional literature, applicable regulatory requirements (e.g., International Standards on Auditing (ISA), International Financial Reporting Standards (IFRS)), discussions with senior auditors regarding the potential value of audit provided to clients, and discussions with preparers of financial statements and supervisory board members charged with oversight of financial reporting and disclosure.

One or two members of the research team conducted the interviews with the CFOs or audit committee members in June and July 2009. Each interview took approximately 30 to 60 minutes to complete. Subjects were informed that the purpose of the study was to examine the value of a financial statements audit as perceived by CFOs and audit committee members of publicly listed companies. They were also told that the interviews are part of a broader study on the value of the financial statements audit that is commissioned by the Standards Working Group (SWG) which is a sub-group of the Global Public Policy Committee (GPPC), the latter representing the six largest international accounting and auditing networks. We furthermore indicated that the identity of the interviewees and the identity of the company will be kept strictly confidential and will not be included in the report and/or otherwise communicated to the SWG, the GPPC or any other third party. To provide subjects with some more background to the study, we furthermore indicated that in the interviews the focus would be on the perceived usefulness of communications with the auditor at various stages of the audit process and on working with the auditor, for example in facilitating the adoption of appropriate accounting policies, the application of accounting standards and the resolution of disclosure questions and issues. Interviews were audio-taped and later transcribed.^{vi} The results reported in Chapter 2 of this report are based on the transcripts. As described above, the use of the interview method has justification as a research method. Nevertheless it should be noted that the normal limitations of this method apply. While the interview method is particularly useful for obtaining contextual information about participants' opinions and experiences, the qualitative nature of the approach and the relatively small number of interviews in this study do not allow generalization of the findings to the wider population of CFOs and audit committee members.

Part B: Survey of financial analysts

Perceptions of sell-side equity research analysts on the value of audit were obtained between June 2008 and July 2009 by means of a self-administered web-based questionnaire survey. Because sell-side equity research analysts are uniquely qualified to provide the required information, and because we are basically interested in opinions on matters that are exclusively internal to them, the use of a questionnaire survey has justification as a research method. Nevertheless, the normal limitations of this method obviously apply. The most important limitations are briefly discussed below.

First, the quality and quantity of information provided by analysts heavily depends on their ability and willingness to cooperate. Although some analysts may see it as their duty to provide the required information, pressure of competing activities is obviously very high. In addition, perceived importance of the topic may increase analysts' motivation to participate. Potentially, this leads to a systematic non-response error in the sense that non-responding analysts may have a less positive view of the value of an audit. To mitigate this threat to the external validity of our study, we undertook the following actions to increase the response rate: (a) we made the invitation to participate and the questionnaire itself as short as possible and easy to read; (b) we offered participants clear response directions; (c) we included personalized communication in the invitation and questionnaire; (d) we used up to three follow-ups. In these follow-ups, we promised to donate 10 Euro to a charity (Doctors Without Borders or Oxfam) for each completed questionnaire. Furthermore, we provided clear information in the invitation, including: (a) the purpose of the survey; (b) the fact that the results will ideally improve auditors' and regulators' awareness of analysts' requirements and perceptions regarding a financial statements audit; (c) the average time it takes to complete the survey; (d) survey sponsorship and the fact that the study's findings will be used to inform discussions with regulators and industry groups; (e) that all answers are strictly confidential and are used only in combination with those of other respondents; (f) that none of the answers provided is linked to analysts' investment advice; and (g) that it does not matter whether an analyst is familiar with the audit profession and its services.

Second, while the survey design attempts to maximize generalizability with respect to the population of analysts, this unavoidably comes at the expense of precision in control and measurement of variables related to their opinions. In addition, the use of a hypothetical scenario in the questionnaire may weaken the realism for the analysts of the context in which the opinions are elicited. We attempt to compensate for this by tailoring the questions to a real public company that an analyst is known to be very familiar with from his or her research activities.

The analysts targeted are covering companies that are publicly listed in the Netherlands, Germany or the United Kingdom (UK). Names and e-mail addresses of analysts as well as the name of their employer were hand-collected from recent research reports that they issued on publicly listed companies in these countries. The research reports were downloaded from the Thomson One Banker database. For each company covered by an analyst, we retrieved for the most recent financial statements: (a) the fiscal year end date; (b) the applicable accounting standards; and (c) the name of the auditor.

Once the questionnaire was constructed and pilot tested, an invitation containing a web link to the questionnaire was e-mailed to 2,274 analysts. In total, 748 e-mails were returned with the message that the invitation was undeliverable, e.g., because an analyst no longer worked for the same employer, or because the mail system of the employer blocked our invitation. From the 1,526 analysts who supposedly received our invitation, 171 fully completed the questionnaire, resulting in an overall response rate of 11 percent. Details of the distribution of the questionnaire, and the responses obtained per country are presented in Table A.

It should be noted that the reported response rate is not uncommon in surveys of analysts. Besides, it is a conservative estimate. Because mail systems may have blocked our invitation without sending a notification, the actual response rate may be considerably higher.

Although it is basically unknown if the opinions of analysts who responded differ from those who did not, we compared early versus late responders to test for indications of a serious non-response error. Early responses were defined as responses received before the first follow-up. Late responses were defined as responses received after the last follow-up. Two different procedures were used to compare early versus late responses: (a) we compared early and late respondents on all scaled items in the questionnaire; and (b) we compared early and late respondents on the number of years of professional experience and on analysts' professional qualifications. In none of the tests that we conducted (not reported here) statistically significant differences in early versus late responses were found, suggesting that there is no indication for a non-response error. In combination with the number of responses received, we conclude that we have obtained a sample that is representative of the population (i.e., analysts covering publicly listed companies in the Netherlands, Germany or the UK), in the sense that the results presented reflect the target population with an acceptable level of precision.

In addition, we checked whether responses for the UK do not differ significantly from responses for the Netherlands and Germany. The main reason for doing so is that the latter were obtained before the dramatic decline in stock prices in the autumn of 2008, while the responses for the UK were obtained afterwards. Our statistical tests indicate that the perceived value of audit has remained equal in every respect but one: we observe that responses for the UK are less positive about the added value of the auditor in improving companies' access to capital and lowering companies' cost of capital (both debt and equity) [$p=0.008$ and $p=0.003$, respectively; two-sided Mann-Whitney U-tests]. A plausible explanation for this is the sharp reduction in the general availability of capital after July 2008.

Table A
Response rates

	Period	Mailed	Received	Completed	Response rate
The Netherlands	June-July 2008	439	314	33	11%
Germany	July-August 2008	886	598	68	11%
UK	May-June 2009	949	614	70	11%
Total		2274	1526	171	11%

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Notes

- ^I We focus on sell-side analysts because they are the primary producers of earnings forecasts. Sell-side analysts tend to be employed at broker-dealer firms that serve individual and institutional investors. Buy-side analysts on the other hand tend to be employed by money management firms or institutional investors. As one input into their own decision process, buy-side analysts may be a user of sell-side analyst reports.
- ^{II} Because our measurement scales are interval scales, we report the mean as a measure of central tendency and the standard deviation (SD) as a measure of dispersion. However, because Shapiro-Wilk tests indicate that the scores are not normally distributed, we also report the median as a measure of central tendency, and the interquartile range (IR) as a measure of dispersion. While the median represents the middle score of an ordered set of observations, the interquartile range shows the lower and upper limits within which the middle 50% of an ordered set of observations fall. In addition, we report the percentage of analysts who assign a score below four (<4) and above four (>4). Considering the distribution of the data, the main measure used to evaluate the degree of perceived confidence, reliance, and agreement by analysts is the median. Given the seven-point scales that we use, a median above four (i.e., five or higher) indicates confidence, reliance, or agreement. In addition, for each item we evaluate if no large proportion of analysts holds a view to the contrary, i.e., assigns a score below four (i.e., three or lower). Whilst acknowledging the arbitrariness of any point measurement used to define “a large proportion”, for the purpose of this research 25 percent was adopted. It was considered that if more than 25 percent of the analysts assign a score below four on any item, then lack of confidence, lack of reliance, or lack of agreement for that particular item are sufficiently widespread to alert the reader. For all additional non-parametric statistical tests that we conduct, statistical significance is referred to in the text as “strong”, “moderate” or “weak” if the two-tailed p -value of the test is ≤ 0.01 , $0.01 < p \leq 0.05$, and $0.05 < p \leq 0.10$, respectively.
- ^{III} Wilcoxon signed-rank tests are used to test for differences among items. The results show that the difference between items (a) and (b) is strongly significant [$p=0.000$; two-sided]. This also goes for the difference between items (a) and (d) [$p=0.000$; two-sided]. The difference between items (b) and (c) is also strongly significant [$p=0.000$; two-sided], as is the difference between items (c) and (d).
- ^{IV} Cronbach's alpha for the summated scales of situation (i) and (ii) is 0.81 and 0.86, respectively. This indicates good internal consistency of the items in the scales. The results of principal component analysis (not reported) further demonstrated that both summated scales are unidimensional.
- ^V In two instances, we did not conduct the interview with the CFO but with the Finance Director or the Corporate Controller as the CFOs were of the opinion that they were in a better position to provide insight in the value of audit to their organisation.
- ^{VI} A few interviews were not audio-taped at the respondents' request. In these instances we took elaborate notes during the interview.

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