The Usefulness of Audit Committee Reports: Assessments And Perceptions

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Abstract

The Treadway Commission has strongly recommended that publicly regulated corporations be required to publish a report by the chairman of the audit committee. In contrast, the SEC does not believe such a report would provide any additional useful information. This study considers the extent to which publication of an audit committee report impacts certain assessments and perceptions related to the financial reporting process. Overall, the results tend to confirm the SEC's belief that inclusion of an audit committee report in the annual report is not likely to provide significant useful information.

Introduction

It is essential that corporate financial statements be reliable for decision making purposes since many business decisions are based on financial information. Accordingly, instances of fraudulent financial reporting are a significant concern to all users of financial statements. For this reason the National Commission on Fraudulent Financial Reporting issued its report specifying steps which should be taken to reduce fraudulent financial reporting in the U.S. [Treadway, 1987].

One of the Treadway Commission's primary concerns was the need for better communications between corporations and financial statement users. In particular, the Commission felt that users should be kept better informed about the roles which corporate management and the audit committee of the board of directors play in the financial reporting process. Therefore, the Commission strongly recommended that corporations be required to present both a management report and an audit committee report in their annual reports to stockholders.

Responding to the Treadway Commission, the SEC proposed rules requiring corporations to include in their annual reports a separate report of management responsibilities for the financial statements and system of internal controls [SEC, 1988]. However, the SEC proposal stops short of requiring that corporations present an audit committee report. Unlike the Treadway Commission, the SEC does not believe that a report of the audit committee would provide any additional useful information. However, there is no research currently available which either supports or refutes the SEC's belief. The purpose of this study is to determine whether a report by the audit committee is capable of providing useful information relevant to the corporate financial reporting process.

Background

Audit committees are composed of from three to five members of a corporation's board of directors. In 1970 only 32 percent of corporations had audit committees, whereas today, more than 80 percent of all publicly traded companies have audit committees. The SEC strongly recommends them, whereas the New York Stock Exchange and the NASDAQ both require audit committees [Ernst and Whinney, 1988]. The general purpose of the audit committee is to oversee the financial reporting process. In fulfilling this purpose the responsibilities of audit committees encompass numerous duties. In fact, since audit committees are such relatively new institutions their specific responsibilities and duties are still evolving.

The Treadway Commission strongly recommended that public corporations be required by the SEC to include in their annual reports to stockholders a letter or a report signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year [Treadway, 1987]. The aforementioned recommendation is based on a belief that the role of the audit committee is largely hidden, whereas it should be more visible and more effectively communicated. Also, the requirement for a report which must be signed can help reinforce the audit committee members' awareness and public acknowledgement of their responsibilities.

Although existing corporate proxy statement disclosures include some information about the audit committee most companies do not present a separate audit committee report. For example, in a study of the progress among large companies toward implementing the various recommendations of the Treadway Commission, Bull and Sharp [1989] reported that none of the companies studied were issuing a signed audit committee report in their annual reports. However, the authors did not suggest any reasons for the lack of reporting by the audit committee. In the absence of an official requirement by the SEC only a few corporations are likely to provide such reports voluntarily.

The SEC does not support a requirement for the presentation of a separate report by the audit committee chairman because it believes such a report would not provide any additional useful information [Hill and Weber, 1988]. However, research is necessary to obtain evidence which either supports or refutes the SEC's reasoning. This study attempts to provide partial evidence based on a consideration of how a report by the audit committee impacts certain assessments and perceptions related to the financial reporting process.

Related Research

There are no significant research studies concerning audit committee reports, but there is prior research related to determining the impact of the external auditor's report. Bailey [1982] suggested that the most viable approach for investigating the information content of an audit report is to compare subjects' perceptions regarding two information sets which have identical financial statement components, but different audit report components. By effectively controlling the financial statement information the researcher is able to focus on the differential impact caused by manipulating the accompanying audit report.

The aforementioned approach was used by Pany and Johnson [1985] to evaluate the difference in information content for the standard form of audit report compared to a proposed revision of the standard report. In that study the participants, CPAs and loan officers, received one of two information sets. Each set contained identical financial statements and background information for a company, but different versions of the audit report. The participants' answers to a series of questions served as the basis for measuring the decision usefulness of the respective information sets and the perceived reliability of the financial statements. The results did not indicate a difference in the financial statement decision usefulness associated with the alternative reports, but there were certain differences in the perceptions of financial statement reliability.

The same approach was also used by Robertson [1988] to assess the differences in the communicative effectiveness of experimental audit reports compared to an unaudited disclaimer report. The participants in the study received identical financial statements and disclosures, but different reports, either an unaudited disclaimer or one of five experimental audit reports. The results revealed fundamental differences in the perceived reliability of the financial statements based on whether they were accompanied by an audit opinion or a disclaimer.

Methodology

Evidence was sought concerning the potential usefulness resulting from the presentation of a separate audit committee report. For this purpose two financial information sets were designed. The sets contained the identical financial statements and footnote disclosures of an actual, but unidentified corporation. Both sets also contained identical external auditor's signed standard unqualified audit reports. The experimental information set also contained an audit committee report signed by the chairman of the committee, whereas the control information set did not include any such report. The wording of the experimental audit committee report was based on the model presented in the Report of the National Commission on Fraudulent Financial reporting [Treadway, 1987]. The information sets were accompanied by a separate instrument containing a series of five questions requiring assessments, and four statements for identifying relevant perceptions.

The Treadway recommendation for presenting a report of the audit committee is based on a concern for fraudulent financial reporting. Therefore, CPAs were chosen as subjects for the current study. Prior research by Pany and Johnson [1985] suggests that CPAs are more aware of the potential existence of fraud than the users of financial statements. In addition to the research by Pany and Johnson, Libby [1979], Mayper et al [1988], Nair and Rittenberg [1987], and Pillsbury [1985] have relied on CPAs as subjects for studies of perceptions concerning the attestation function and financial reporting.

Exhibit 1 presents the background information for participants in the study. There were 31 CPAs in the control group and 43 CPAs in the experimental group. All of the participants were members of international public accounting firms; most were managers; most were working in the auditing area; and the majority were very familiar with corporate financial reporting. The average number of years of public accounting experience for the control group members was 8.98 and for the experimental group 7.27 years.

Results

The written instructions given to the participants requested that they first review the enclosed financial statements including notes, and then read the accompanying audit report, or in the case of the experimental group, the audit report and audit committee report. After completing these steps the participants were instructed to provide assessments for five statements pertaining to qualities of the information set by indicating a probability estimate (from 0% to 100%) for each statement. The results are presented in Exhibit 2.

For each of the statements listed in Exhibit 2 the average of the assessment percentages for both groups, control and experimental, are presented. For example, the control group assessed the probability of a material error in the published financial statements to be 13.97%, whereas the experimental group assessment on average was 11.91%. A comparison of the means in Exhibit 2 suggests that the presentation of a signed audit committee report apparently had a desirable influence on the perceived reliability of the financial statements, as evidenced by the experimental group's lower probability assessments for the existence of error (11.91%), fraudulent financial reporting (10.44%), departures from GAAP (12.79%) and lack of consistency (11.42%). However, an application of the Mann-Whitney test for differences in means indicated there were no statistically significant differences between the means of the two groups. This suggests that the SEC is perhaps correct in deciding against introducing a requirement that corporations publish audit committee reports.

The second part of the instrument was designed to elicit the perceptions of the participants with respect to four statements concerning financial reporting and audit committees. Specifically, the participants were required to indicate the extent of their agreement or disagreement with statements about: the credibility of the enclosed financial statements; the impact of an audit committee; the importance of communicating the audit committee's responsibilities to others; and whether the information set contained adequate communications about the audit committee. A seven-point scale was used wherein: strongly agree = 1; agree = 2; mildly agree = 3; neutral = 4; mildly disagree = 5; disagree = 6; and strongly

Exhibit 1
Participants' Background Information

	Control Group	Experimental Group
Average Years of Public Accounting Experience	8.98	7.27
Title:		
Partner	3	4
Manager	20	23
Senior	8	16
	31	43
Primary Area of Responsibility:		
Auditing	25	36
Tax	5	4
Accounting and Review Services	1	1
Management Advisory Services	0	2
	31	43
Extent of familiarity with corporate financial reporting:		
Very Familiar	21	26
Familiar	8	11
Somewhat Familiar	2	6
Unfamiliar	0	0
	31	43

Exhibit 2
Participants' Assessments

Critical Statements	Mean Assessment Percentages: Control Group	Experimental Group	Level
1. The probability of a material error in the financial statements or accompanying notes is	13.97%	11.91%	.31
2. The probability of material fraudulent financial reporting in the financial statements or accompanying notes is	11.74%	10.44%	.13
3. The probability that the financial statements or accompanying notes contain a material departure from generally accepted accounting principles is	13.58%	12.79%	.35
4. The probability that generally accepted accounting principles have not been consistently observed in all material respects during the current period in relation to the preceding period is	12.26%	11.42%	.24
5. The probability that disclosures in the financial statements or accompanying notes are not adequately informative of important matters is	17.71%	19.02%	.68

agree = 7. The results are presented in Exhibit 3 in terms of the mean response by group for each statement, and t-test results for the differences in group means.

The first statement in Exhibit 3 was designed to determine whether the inclusion of the audit committee report influenced the perceived credibility of the financial statements. For this purpose two different forms of statement one were used, i.e., the statement provided in the experimental group instrument was based on the phrase shown in the parenthesis, whereas, the control group statement made no mention of an audit committee report. According to Exhibit 3 both groups tended to agree (2.065 and 1.977) with statement one despite having different information sets and different versions of statement one. Apparently, the perceived credibility of the financial statements was not enhanced by the inclusion of the audit committee report. One possible reason for this result is that the audit committee report may only serve to reaffirm the basic message already conveyed in the auditor's report. Consequently, incremental information relevant to financial statement credibility is not provided in an audit committee report.

The second and third statements in Exhibit 3 concern the importance of audit committees and whether information about them should be communicated to others. The results, as anticipated in advance, were substantially the same for the control and experimental groups. Both groups tended to agree (2.226 and 1.907) that the existence and effective functioning of an audit committee of the board of directors enhances the reliability of the financial reporting process for corporations. Also, both groups at least mildly agree (2.903 and 2.581) that it is important for users of financial statements to have information concerning the audit committee's acknowledgement of its responsibilities for the corporate financial reporting process. However, this is not to suggest that such an acknowledgement must be formally expressed in a separate written communication within the annual report.

The fourth statement in Exhibit 3 was deliberately intended to provoke divergent results, since the experimental group information set contained an audit committee report and the control group set did not. Therefore, not unexpectedly the control group tended to disagree

Exhibit 3
Participants' Perceptions

Statements	Control Group Mean	Experimental Group Mean	Critical t-Value	Level
1. The auditor's report (The auditor's report in conjunction with the audit committee's report) adds credibility to the financial staements and accompanying notes.	2.065	1.977	.355	.80
2. The existence and effective functioning of an audit committee of the board of directors enhances the reliability of the financial reporting process for corporations.	2.226	1.907	1.431	.20
3. It is important for users of financial statements to have information concerning the audit committee's acknowledgement of its responsibilities for the corporate financial reporting process.	2.903	2.581	1.164	.30
4. The information set accompanying this questionnaire adequately communicates information regarding the major responsibilities of the audit committee of the board of directors.	5.742	2.953	8.953	.001

(5.742) with statement four, but somewhat surprising is the lack of strong agreement by the experimental group, only 2.953. Although the audit committee report used in the experimental group information set was adapted from a model presented in the Treadway Commission report, apparently several of the participants perceived the communications to be inadequate. Perhaps a more detailed and much lengthier form of report is necessary to achieve adequate communications of audit committee activities. However, it is not a certainty that the benefits would justify the additional costs of such reporting.

Conclusion

Audit committees are recognized as having vital oversight responsibilities for the corporate financial reporting process. However, contrary to the Treadway Commission, the evidence in this study suggests that the inclusion of an audit committee report in the annual report is not likely to provide significant useful information. Although certain information about audit committees is important, alternative information sources are available which do not entail a separate formal reporting requirement.

Existing corporate proxy statement disclosures currently include information about the functions of the audit committee; the number of meetings held; and the names of committee members. Furthermore, as a part of their annual reports, many corporations regularly provide a management responsibility report which usually includes a description of the audit committee function. Therefore, it seems the SEC is correct in not establishing a requirement that corporations publish a signed report of the audit committee.

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