Has the time come to change the auditor’s report to develop a different grading system and increase the value of auditing to society?

Regulatory attempts to improve the functioning of capital markets often try to make corporate activities more transparent. The International Auditing and Assurance Standards Board (IAASB) invited comments on its proposals contained in “Improving the Auditors Report,” with an exposure draft expected to be issued by June. These proposals are intended to make the audit report more useful, and to better communicate the role of auditors. Auditors’ boilerplate, essentially pass/fail, reports reveal little of the fine-grained understanding they gain about the inner workings of their clients, including internal controls, accounting policies, disclosure and governance.

The IAASB proposes to replace the current three-paragraph standard by a new four-page report that will add two new elements: an opinion about management’s use of the going concern assumption and an auditor commentary. The rationale for this five- or six-fold expansion under the proposal is that the commentary should help users better understand the audited financial statements and the audit. A sample report in the proposal includes comments on litigation, goodwill, financial instruments, and audit strategy for verifying revenue, receivables and cash receipts, the entity’s internal control over these items, involvement of other auditors, responsibilities of management and responsibilities of the auditor.

Repeated burials do not seem to prevent some bad ideas for audit regulation from being resurrected periodically. Auditor opinion on the going concern and financial viability of a company is one of these zombies. The going concern assumption already undergirds a clean audit report, which cannot be issued if the auditor has any doubts. Beyond that, the auditor has no special insight on the future viability of a company. Requiring further opinion from auditors will either induce them to wait until doubts about the continued viability of the firm become common knowledge or issue advance warning about such doubts. The former is worthless because by then the horse would have escaped the proverbial barn. The latter will likely prove to be a self-fulfilling prophecy and cause the client to fail. Either way, this part of the proposal does little to improve auditing or financial reports.

The major substantive proposal for an auditor commentary will revive the early practice of a detailed oral report...
motivates agents (organizations) to work hard and identify better audit practices through international comparisons have diminished. However, we can still draw inferences about alternative reporting practices through cross-sectional comparisons of accounting and auditing with other sectors of the economy. What would, or should, audit reports be in a completely unregulated market? Dubey and Geanakoplos’ benchmark model for an optimal grading system suggests three properties:

**An intermediate number of reporting grades (five or 10 possible grades)** This reporting scale is informative and motivates agents (organizations) to work hard to improve their grade. A pass/fail report is suboptimal since it is less

informative and does not motivate agents to work harder. On the other hand, measurement errors vitiate excessively fine grading schemes (e.g., 100 possible grades).

**A small elite grade** Making it hard to get an A allows only ex-ceptional performers to get it, increasing the incentive for improvement.

**An absolute grading scale** Grading should be done on an absolute scale (e.g., 90-plus = A), not on a curve. An absolute scale gives all agents an incentive to exert effort to improve their grade.

Jamal and Sunder examine the availability of standards and certification for 817 goods and services in the economy. Private-sector certification is characterized by some use of pass/fail standards (e.g., Underwriters Laboratory seals on electrical appliances), but more frequent use of five-, 10-, and even 100-point scales for a wide variety of goods and services. It is common to have different experts (e.g., wine raters) trying to differentiate themselves from competitors in part by adopting a different reporting scale. Jamal and Sunder also show that new entrants in a baseball-card rating market try to differentiate their certification service by increasing the number of grades in their reporting system, providing hard-to-get elite grades and not grading on a curve.

The norm in private-certification markets is to have a choice among certification agencies that have their own proprietary standards and use different sets of reporting scales (e.g., TRUSTe versus BBB Online versus WebTrust for e-commerce privacy seals7, 8). In financial reporting this would be analogous to each of the Big Four audit firms creating their own differentiated scales for grading audit reports (just as Moody’s and Standard & Poor’s do for bond ratings). It is also common for private certifiers to provide more transparency by issuing subgrades and explaining how the overall grade is determined. For example, in the baseball-card certification market, Beckett Grading Service provides an overall score as well as subgrades for centring, corners, edges and surfaces.

An equivalent audit report would provide an overall grade for quality of financial reporting and subgrades for features of the financial statements and systems, such as the quality of an organization’s internal control system, governance, propriety of accounting policies and quality of disclosure.

An alternative arrangement would be to create an elite reporting group of companies that agree to meet a higher standard of internal control, governance, accounting quality and disclosure (e.g., AAA-graded beef meets a higher standard, although other grades are also rated fit for human consumption). The auditor’s “gold seal” issued to these companies would be available for reporting to audit committees and users of financial statements.

The current audit report does not help realize and deliver the value potential of auditing for society. While an auditor commentary has potential to be useful, it also has the risk of becoming simply more mindless and noisy verbiage under which the real news gets buried. There is definitely a need to develop more informative audit reports to increase the value of auditing to society. More freedom to auditors and their clients in demanding and devising more informative audit reports may encourage evolution towards that goal.

**References**


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