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How Can Auditors And Audit Committees Encourage Managers To Disclose Risks To Investors?

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In settings where both the audit committee is highly effective and the financial statement auditor intends to issue a more detailed audit report, corporate managers are more likely to disclose risks to investors. Importantly, more effective audit committees or more informative audit reports alone do not encourage managers to be more transparent, according to a study forthcoming in The Accounting Review.

In an article titled "The Effect of Auditor Reporting Choice and Audit Committee Oversight on Management Financial Disclosures" researchers performed an experiment with 145 financial executives from U.S. publicly traded companies. The vast majority of the executives were chief financial officers. The article is authored by Stephen Fuller of Suffolk University, Jennifer Joe from the University of Delaware, and Benjamin Luippold of Babson College.

“We conducted an experiment with highly experienced executives who provided disclosure decisions based on a case. In the case, we varied the content of the auditor’s critical audit matter discussion regarding a subjective financial reporting issue, as well as how vigorously the audit committee conducted its oversight of financial reporting,” says Fuller.

In the experiment, managers only increased their public disclosures when the auditor provided a more detailed discussion of the subjective financial reporting issue in its report and the audit committee oversight was highly effective. Specifically, a highly effective audit committee was composed of financial experts who were more actively involved in discussions of accounting and disclosure issues. “We also found that the improved management disclosures were quantitative in nature which would likely be valuable to investors. It surprised us that neither of the factors we studied were sufficient on their own to motivate improved disclosure,” states Fuller.

The study describes concerns that have been expressed over auditor reporting of critical audit matters becoming “boiler-plate” and being no more informative to investors than the prior “pass/fail” audit report. Such concerns may be valid. When the auditor’s reporting of the accounting issue was more “boiler-plate,” managers in the experiment were less apt to publicly disclose risks associated with the accounting issue. “Given our findings, we encourage auditors to provide a meaningful discussion of critical audit matters in their reports and audit committees to be more diligent in performing their responsibilities. We feel that will result in investors receiving the information about company risks that they crave,” says Fuller.

Fuller concludes, “There is a lot of research currently being performed in this area. The first wave of public company reporting with the new expanded audit report has just happened and so we will begin to see how auditors have implemented the new

standard. In addition, more research is needed to fully understand how a variety of stakeholders make decisions related to critical audit matters."

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