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Greg Shields, CPA, CA
Director, AASB
Auditing and Assurance Standards Board
277 Wellington Street West
Toronto, Ontario M5V 3H2

AASB Exposure Draft Auditor Review of Interim Financial Statements, November 2013

Dear Sir,

I am pleased to provide comments on the Exposure Draft – Auditor Review of Interim Financial Statements, issued in November 2013 by the AASB. My comments are based on the results of research studies performed worldwide on auditor assurance on interim financial statements as well as a research project on auditor review of quarterly financial statements for Canadian public companies performed at the Chair of corporate governance of Laval University. A research article, coauthored with Lucie Courteau from University of Bolzano- Bolzen, from this project is forthcoming in Contemporary Accounting Research (Bédard and Courteau 2013). A professional version of the article is included with this letter.1

The Exposure Draft (ED) – Auditor Review of Interim Financial Statements, contains the following main features:

   a. Rewriting of the previous standard, based on the “clarified” format used for the auditing standards,
   b. Keeping the focus on providing assistance to the audit committee instead of on rendering assurance on the interim financial statements. Consistent with this focus, the ED contains the following requirements:
      i. Allowing oral communication of the interim review report (new requirement),

ii. Restricting the use of the report to the audit committee for its assistance in reviewing the interim financial statements (current requirement),

iii. Prohibiting the auditor to issue a written consent to the inclusion of the auditor’s interim review report in a public document unless required by law (current requirement),

c. “new” requirements which as stated in the ED, primarily reflect matters that were formerly guidance and improve the clarity of previous guidance,

My response to the ED addresses two key points:

1. The prohibition for the auditor to issue a written consent to the inclusion of the auditor’s interim review report in a public document; and

2. The effectiveness of the interim reviews in improving the quality of interim financial statements.

1. Prohibition to make the report public

In the ED, the AASB reiterated the prohibition for the auditor to make the review report public by prohibiting the auditor to issue a written consent to the inclusion of the auditor’s interim review report in a public document. Two main justifications are provided in the ED:

a. Compared to audit committee members, who are aware of the limitations of an interim review and the lower level of assurance provided by such a review as compared to that provided by an audit, investors and investment analysts may not always be familiar with the limited level of assurance provided by an interim review (pages 1 and ii).

b. Because, “[A]n interim review does not result in the auditor expressing an opinion on the interim financial statement”, it “may be inappropriate for directors, officers and others to rely on the auditor’s interim review report as the report of an expert in the discharge of their responsibilities” (page 17).

In the following paragraphs, I evaluate these two justifications and question their validity.

a) Lack of users knowledge

I do not believe that the lack of users’ knowledge of the lower level of assurance provided by a review as compared to that provided by an audit is a valid justification for the following reasons:

- Under current securities regulation, when an auditor has not reviewed the unaudited interim financial statements, companies must disclose this fact. Accordingly, when such a notice is missing, investors should assume that the interim financial statements have been reviewed by the company auditor. They may then infer that the quality of these financial statements is higher than non-reviewed one and react more to the information communicated. On the other hand, because of the absence of a report, they have no way to evaluate the level of assurance provided. They may assume it is nil, lower than that provided by an audit, or even equal.

As part of a research project conducted at the Chair in corporate governance, by Carl Brousseau and myself, we are examining investors’ perception of the interim reviews.
Preliminary results indicate that the stock market response to unexpected quarterly earnings disclosure by Canadian companies is similar for reviewed and non-reviewed interim financial statements (first three quarters). This result suggests that investors do not perceive that reviewed interim financial statements are more reliable than non-reviewed ones. For the fourth quarter, however, the reaction is stronger, suggesting that investors believe that the fourth quarter unexpected earnings are more reliable when previous quarters financial statements were reviewed. A possible explanation for this result, is that investors believe that the fourth quarter unexpected earnings are less likely to be caused by year-end adjustments, when the interim financial statements have been reviewed. Thus, investors making inference about the level of assurance provided by a review without the necessary information to make such a judgment.

- Results from auditing research do not support the lack of knowledge assumption. For example, Hasan et al. (2003) find that shareholders do perceive that negative assurance reports (review reports) provide a lower level of assurance than that provided by a high assurance report (audit).
- Finally, review reports are public in many other countries (e.g. United-Kingdom, Australia, France) and I never heard of major problems causes by these disclosure. Even in the US, where the public disclosure of review reports is not mandatory, some companies are voluntarily making them public. Thus Krishnan and Zhang (2005) find that 5.7% of their sample of companies (1,893 firms for the first quarter of 2000 and 2,458 for the first quarter of 2001) disclosed the auditor’s review report in their filings. They view the disclosure of the review report as the results of an auditor-client negotiation and argue that the report is included in 10-Q filings when the benefits to the auditor and to the client exceed the costs to both parties.

b) Lack of audit opinion

The auditor may issue two level assurance, a high that result in an audit opinion report and a moderate level that result in a negative assurance report. Accordingly, the audit report and the review report are merely ways to express the level of assurance provided by the auditor. In both cases the audit committee can rely on the report. The only difference is that the level of assurance provided by the expert is lower for the review.

2. Reviews’ effectiveness

Interim reviews are believed to improve the quality of interim reporting by allowing the timely consideration of significant accounting matters affecting the interim financial statements and reducing the likelihood of restatements or other adjustments in the fourth quarter. Results from early research on the benefits of interim reviews in the US are not consistent with these expectations (e.g. Givoly et al. 1978; Alford and Edmonds 1981). More recent studies compare interim and retrospective reviews of quarterly reports in US firms. Ettredge et al. (2000) show that, for the years 1989 and 1990, 131 firms with interim reviews recorded a higher proportion of non-routine adjustments during the first three quarters and a lower proportion in the fourth quarter than 69 firms with a retrospective review. Similarly, Manry et al. (2003) find that, between 1990 and 1995, their 412 sample firms with interim reviews have a higher contemporaneous association between returns and interim-quarter earnings than 84 firms with
retrospective reviews, suggesting that reviewed quarterly earnings “better” reflect the economic information that is impounded in returns.

In Canada, Bédard and Courteau (2013) analysed a large sample of quarterly financial statements by Canadian listed companies for the years 2004 and 2005. In these years, 59 per cent of the companies studied had a review of their interim financial statements. The total fees for auditing services increased by 18 per cent when the auditor reviewed the quarterly financial statement. To determine the quality of the interim financial statements, we looked at the abnormal accruals – the difference between net income and cash flows from operations unexplained by a prediction model, and the timing of the recognition of non-routine adjustments to quarterly earnings. These figures were then compared for companies with and without interim reviews. There was no statistically significant increase in the quality of the quality interim financial statements when reviews are performed.

Possible reasons why interims reviews do not seem to improve the quality of interim financial statements for Canadian companies are:

- Focusing on providing assistance to the audit committee instead of on rendering assurance on the interim financial statements, may result in less assurance work than if the focus was on rendering assurance on the interim financial statements.
- The review report not being visible, auditors have less incentive to perform higher quality review.
- Interim reviews are not subjected to CPAB inspections, they cannot benefit from this quality control system.
- The requirements of the review standards are not strong enough to add value to the quality of interim financial statements (Boritz 2006).

Recommandations
Based on the previous discussion, I make the following recommendations:

1. That the standard allows the auditors to issue a written consent to the inclusion of their interim review report in a public document, and
2. That the AASB explore ways to strengthen the requirements for interim review.

I hope that my comments will be helpful to you in your revisions to the interim review standards.

Yours truly,

Jean Bédard, Ph.D., FCPA, FCA, auditeur
References


