Does the reporting of key audit matters affect the auditor’s report’s communicative value? Experimental evidence from investment professionals

ABSTRACT

This paper investigates the communication of key audit matters (KAM) in the auditor’s report as required by the new International Standard on Auditing (ISA) 701. We conduct an experiment with investment professionals to test the communicative value of a KAM section relating to goodwill impairment. Our main results show that in the condition in which the KAM section suggests that already small changes in the key assumptions could eventually lead to a goodwill impairment (referred to as KAM negative), participants assess the economic situation of the company to be significantly better as compared to the condition in which the KAM section suggests that only large changes in the key assumptions could eventually lead to a goodwill impairment (referred to as KAM positive). We interpret our findings in light of a model of trust and conclude that the specific informational content of the KAM section triggers different factors in the model in different ways. Overall, our findings suggest that neither preparers nor audit committees or auditors need to fear that the disclosure of critical entity-related information leads to negative implications; rather, financial statement users value this information positively.

JEL Classification: M42

Keywords: improved auditor’s report, key audit matters, communicative value, trust model
I. INTRODUCTION

Since the 1970s, there have been numerous discussions about the need for improving the auditor’s report as the auditor’s primary means of communication with a company’s stakeholders (see, for instance, regarding the history PCAOB 2011). The financial crisis has further spurred financial statement users (in the following referred to as users), but also regulators and national standard setters to address the auditor’s role in early warning signaling and in the provision of additional insights into audited financial statements. Very recently, various institutions and regulators, such as the Center of Audit Quality (CAQ), the European Commission (EC), the International Auditing and Assurance Standards Board (IAASB), the Public Company Accounting Oversight Board (PCAOB), and the United Kingdom Financial Reporting Council (FRC), have started initiatives to improve the auditor’s reporting model – also with respect to further insights into the auditor’s work. Given the IAASB’s position as a global standard setter whose auditing standards have been adopted in over 100 countries, the IAASB initiative is of particular interest. A promising way to provide users with more information about the auditor’s work and, thus, to enhance the communicative value of the auditor’s report, is a separate section in this report that communicates so-called key audit matters (KAM), i.e., “matters that, in the auditor’s professional judgment, were of most significance in the audit […]” (IAASB 2015b, paragraph 11, a)). This concept is reflected by the new IAASB audit standard ISA 701 ‘Communicating Key Audit Matters in the Independent Auditor’s Report’, which was published in January 2015 and is effective for audits of financial statements ending on or after December 15, 2016.

There is scarce evidence on whether the inclusion of a separate KAM section in the auditor’s report as required by ISA 701 will meet the IAASB’s objective to enhance
the communicative value of the auditor’s report for users. Prior auditor reporting research has primarily examined the effect of additional or amended content in the auditor’s report on the expectation gap, i.e., “the difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is” (IAASB 2011, 7) and/or the potential narrowing thereof. One stream within this research uses revisions or draft revisions of relevant auditor reporting standards and their potential impact on the expectation gap (e.g., Bailey, Bylinski, and Shield 1983; Kelly and Moorweis 1989; Houghton and Messier 1991; Miller, Reed, and Strawser 1993; Monroe and Woodliff 1994; Kneer, Reckers, and Jennings 1996; Innes, Brown, and Hatherly 1997; Gold, Gronewold, and Pott 2012). Another stream examines different designs of auditor’s reports (such as ‘plain English’ report format with the opinion at the end or at the beginning, e.g., Chong and Pflugrath 2008). A third stream examines additional – at least at the time of the respective study not required – information in the auditor’s report such as materiality (e.g., Fisher 1990; Davis 2007) or corporate governance information (e.g., Manson and Zaman 2001).

The overarching purpose of the current IAASB initiative with respect to the communication of KAM is to provide information about the auditor’s work and, therefore, to enhance the communicative value of the auditor’s report for users (IAASB 2011).

1 We are aware of one working paper (Sirois, Bédard, and Bera 2014) that uses eye-tracking technology to examine whether and how additional information on KAM affects how users navigate through and integrate the information presented in the related financial statements. However, Sirois et al. (2014) use post-graduate accounting students as surrogates for the users of financial statements, while we are able to capture users more directly by conducting our experiment with investment professionals. Sirois et al. (2014) find that the communication of additional information is associated with lower perceived audit quality and a perception that the level of assurance varies across components of the financial statements – a result that is contrary to the standard setters’ expectation. Christensen, Glover, and Wolfe (2014) also do not use real investment professionals in their study about critical audit matter (CAM) paragraphs, but business school graduates. They find that participants who receive a CAM paragraph emphasizing the audit issue related to the audit of uncertain fair value estimates are more likely to stop investing in the company than participants who receive an auditor’s report without a CAM paragraph or who receive the information from the CAM paragraph as part of management’s footnotes. However, the effect of the CAM paragraph is mitigated when it is followed by a paragraph offering resolution of the CAM. There are few other working papers that examine the effect of CAM paragraphs on auditor liability (Backof, Bowlin, and Goodson 2014; Brasel, Doxey, Grenier, and Reffett 2015; Gimbar, Hansen, and Ozlanski 2015).
The objective of this study is to experimentally examine the potential effect of a separate KAM section in the auditor’s report as required by ISA 701 on the auditor’s report’s communicative value for users.

Using a between-subjects experimental design among 89 investment professionals from Germany (82.28 percent), US, UK or Canada (10.12 percent), and other countries around the world (7.60 percent), we test whether the new KAM section in the auditor’s report is associated with communicative value for investment professionals. In doing so, we capture the auditor’s report’s communicative value by two dimensions, the potential to change the user’s assessment of the company’s economic situation and the user’s confidence in making that assessment. With these two dimensions, we capture the main assessments within investment professionals’ analyses and/or investment decisions. We therefore assume that the communicative value of the auditor’s report changes if user’s assessments in either of these two dimensions change.

In our experiment, we manipulate the auditor’s report by including a KAM section that relates to goodwill impairment, whereby we refer to the KAM goodwill example in the illustrative auditor’s report outlined by the IAASB in its exposure draft ‘Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)’ (IAASB 2013). Assuming that the specific informational content of the KAM section triggers the different factors in a model of trust in different ways – which in turn has the potential to affect our results – we differentiate between two content-related2 manipulations: (1) A KAM section suggesting that already small changes in the key assumptions could eventually lead to a goodwill impairment. We refer to this manipulation as a KAM section with a negative tendency regarding the

2 Consequently, the focus of our research differs from other studies where presentation format is manipulated but information content stays the same (see literature review in section 3 for auditor reporting related studies and Libby and Emett (2014) for a recent review of the effects of earnings presentation attributes on manager and user behavior).
company’s economic situation, or, in short, KAM negative. (2) A KAM section suggesting that only large changes in the key assumptions could eventually lead to a goodwill impairment. We refer to this manipulation as a KAM section with a positive tendency regarding the company’s economic situation, or, in short, KAM positive.\(^3\) The control group is provided with the former ISA 700 auditor’s report (without separate KAM section).

Intuitively, it seems reasonable to expect the users’ assessment of an entity’s economic situation to be more negative if the auditor’s report includes a KAM section with a rather negative tendency as compared to a KAM section with a rather positive tendency. Regarding our second dimension of communicative value, i.e., the user’s confidence in the assessment of the company’s economic situation, users should be more confident in their assessment of the company’s economic situation if the auditor’s report includes a KAM section at all – regardless of the specific KAM tendency. That is because the informational basis for users’ assessment becomes larger by the provision of KAM and hence, information asymmetry is reduced in both conditions.

\(^3\) Literally, if the auditor outlines that already small changes in the key assumptions could eventually lead to a goodwill impairment, he or she signals a high risk that an impairment will occur in the future which then would negatively affect net income and hence, the economic situation of the company. On the contrary, if the auditor outlines that only large changes in the key assumptions could eventually lead to a goodwill impairment, he or she signals a low risk that an impairment will occur in the future and hence, a low risk that net income/the economic situation of the company will be affected. Therefore, we refer to the former as KAM negative and to the latter as KAM positive. Furthermore, IASs are silent on specific tendencies of KAM sections. Hence, the communication of KAM does not necessarily imply a negative tendency. In the UK, the reporting of risks of material misstatement, which are conceptually equivalent to KAM, is required for auditor’s reports with effect for periods commencing on or after 1 October 2012. A review of the experience with the new requirements reveals that “goodwill impairment” ranks on the third position among the most reported instances of risks (FRC 2015). Furthermore, an in-depth analysis reveals that the sections on goodwill impairment and other risks within the auditor’s reports are not generally conveying negative tendencies (see for example section on risks due to capital restructuring in the auditor’s report for New World Resources plc; New World Resources 2014), but also positive tendencies (see for example section on goodwill impairment risks in the auditor’s reports for Pearson plc and Greggs plc; Pearson 2014; Greggs 2014). These findings do not only underline the relevance of the goodwill impairment setting we chose for our experiment, but also provide initial anecdotal evidence for the relevance of considering KAM sections with negative and positive tendencies.
However, based on the implications of trust literature and a model of trust, which we propose to apply in our study in order to explain the potential effect of a new KAM section in the auditor’s report on the communicative value for users, expectations change. In line with this theoretical framework, we find that in the KAM negative condition, participants assess the economic situation of the company to be significantly better as compared to the KAM positive condition. Correspondingly, the descriptive results indicate that participants’ confidence in their assessment is higher in the KAM negative condition. Thus, based on a model of trust we conclude that the specific informational content of the KAM section triggers different factors in the model to different degrees, eventually leading to unequal levels of trust which the investment professionals associate with the auditor’s report. This divergence in perceived trustworthiness of the auditor’s report will then also alter the perceived trustworthiness of the financial statements and hence, the user’s assessments of the company’s economic situation and the user’s confidence in making that decision. These results suggest that from a users’ perspective the KAM section with a positive tendency is rather ill-perceived as a kind of appeasement given the challenges the auditor had faced during the audit, while the KAM section with a negative tendency is rather well-perceived as a helpful signal that draws the users’ attention to issues that they had not been aware of before. Thus, neither preparers nor audit committees or auditors need to fear that the disclosure of critical entity-related information leads to negative implications; in contrast, users value this information positively.

This study contributes to the auditor reporting literature in at least three ways. First, it extends the very scarce literature on the potential effect of the KAM section in the auditor’s report on the communicative value for users by using real investment professionals. The participants of our experiment are investment professionals from more than one country which has two main advantages. One, we do not have to refer to
surrogates for users, such as graduate accounting students; we rather directly examine the assessment of one of the most important user groups. Two, given that our investment professionals are from more than one country, we believe that our findings are not restricted to a certain jurisdiction. Second, to the best of our knowledge, this is the first study that examines the potential effect of the additional information about KAM in the auditor’s report by considering different tendencies of KAM on the communicative value for investment professionals. Our findings are useful for standard setters and auditors by highlighting the importance of carefully phrasing a KAM section, also considering how users’ perceive the message conveyed with the KAM section. This aspect is highly relevant because the identification and communication of KAM are subject to the auditor’s professional judgment. Third, by referring to a model of trust that theoretically explains why different tendencies of KAM potentially lead to different user’s assessments of aspects related to the communicative value, we employ an innovative approach in the auditor reporting literature not used thus far.

The remainder of this study is structured as follows. Section 2 provides background information on the IAASB’s initiative to improve the auditor reporting model. Section 3 reports prior research and in section 4, we develop the paper’s hypotheses. Section 5 describes the experimental design as well as the participants. Section 6 reports the results as well as robustness checks, and section 7 concludes.

II. BACKGROUND

Starting point for the IAASB’s initiative to enhance the value of auditor reporting is the fact that the auditor’s report per se is valued (e.g., Mock, Turner, Gray, and Coram 2009; MARC 2010), but that the message conveyed by the auditor’s report beyond the ‘pass-fail-conclusion’ has been questioned by both regulators and researchers since decades (e.g., Commission on Auditor’s Responsibilities 1978; Geiger
1993; Church, Davis, and McCracken 2008; Smeliauskas, Craig, and Amernic 2008; Mock, Bédard, Coram, Davis, Espahbodi, and Warne 2013). A major concern is the little communicative value of the auditor’s report and related to that a call for more information primarily on insights into the auditor’s work (IAASB 2013). The exposure draft ‘Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)’ published by the IAASB in July 2013 is a culmination of IAASB’s considerations regarding the auditor reporting topic, to which international research, public consultation, and stakeholder outreach undertaken by the IAASB contributed. Preceding projects in this process are the jointly commissioned international research on user perception of the standard auditor’s report, the May 2011 Consultation Paper ‘Enhancing the Value of Auditor Reporting: Exploring Options for Change’ (IAASB 2011), the June 2012 Invitation to Comment (ITC) ‘Improving the Auditor’s Report’ (IAASB 2012), global roundtables and additional outreach to solicit feedback on the indicative direction outlined in the June 2012 ITC, as well as continued monitoring of, and interaction with, policymakers and national standard setters with auditor reporting initiatives (IAASB 2013, 6). One of the key enhancements to auditor reporting suggested is the communication of KAM. After the issuance of an exposure draft in 2013, the final auditing standard ISA 701 ‘Communicating Key Audit Matters in the Independent Auditor’s Report’ was published in January 2015 and will be effective for audits of financial statements for periods ending on or after December 15, 2016. This standard includes requirements and guidance for the auditor’s determination and communication of KAM. KAM have to be communicated in a separate section in the auditor’s report for audits of full sets of general purpose financial statements of listed entities. Each KAM has to be described in the KAM section headed “Key Audit Matters” whereby appropriate subheadings have to be used for each individual KAM (IAASB 2015b, paragraph 11). Examples for KAM include for instance: Goodwill,
valuation of financial instruments, and effects of new accounting standards (IAASB 2013, IAASB 2015b; see also IAASB 2015a).

In our experiment we use one of the IAASB (2013) KAM examples and refer to goodwill impairments. We only manipulate the KAM section and do not consider the other amendments of the auditor’s report resulting from the new Auditor Reporting Model in order to isolate the effect the separate KAM section potentially has on the communicative value of the auditor’s report for users. Following this approach, we do not consider any re-ordering of the individual auditor’s report sections. Hence, the KAM section in the manipulated report is placed at the end of the auditor’s report.

III. PRIOR RESEARCH

Prior experimental/questionnaire auditor reporting research has primarily focused on the effect of amendments of the auditor’s report on the expectation gap or the potential reduction thereof. One stream within this research uses revisions or draft revisions of relevant auditor reporting standards. Bailey et al. (1983) demonstrate that users perceive a shift of financial statement-related responsibilities from the auditor towards management in the desired way due to the suggested wording changes in the auditor’s report as proposed by the American Institute of Certified Public Accountants (AICPA). They also find that more experienced and knowledgeable users are better aware of auditor’s versus management’s responsibilities. In line with the former Bailey et al. (1983) finding, the at that time new Statement on Auditing Standards (SAS) No. 58 ‘Reports on Audited Financial Statements’ enhanced the understandability in terms of the audit objective and the responsibilities of management for financial statements (Kelly and Moorweis 1989; Miller et al. 1993). Houghton’s and Messier’s findings (1991) are also related to SAS No. 58 by showing that the exposure draft auditor’s report under SAS No. 58 leads to a better alignment of CPAs’ and bankers’ assessment
of the report. Kneer et al. (1996) support that changed wording in the auditor’s report under SAS No. 58 can affect users’ perceptions of auditor’s responsibilities whereby SAS No. 58 has “achieved modest success” (p. 25). Australia followed the US example of SAS No. 58: The suggested changes to their standard on auditor’s reports are content of Statement of Auditing Practice (AUP) No. 3 issued by the Australian Accounting Research Foundation (AARF). While the proposed new version of the auditor’s report eliminated some differences between auditors’ and various other users’ perceptions, for instance in terms of auditors’ responsibilities, the changed wording gave also room for new differences in areas not subject of the report, for instance fraud (Monroe and Woodliff 1994). The British analogue to SAS No. 58, Statement of Auditing Standards No. 600 ‘Auditor’s Reports on Audited Financial Statements’, led to a reduction of the expectation gap (Innes et al. 1997; Manson and Zaman 2001). Gold et al. (2012) use the revised ISA 700 at that time and test whether the related additional explanations in the revised auditor’s report reduce the expectation gap. One of their main findings is that the revised ISA 700 does not lead to a reduced expectation gap. Based on that they conclude that the audit opinion alone “may signal sufficient relevant information to users” (p. 286).

Another stream of prior auditor reporting research examines auditor’s report format changes on stakeholders’ and auditors’ perceptions. Chong and Pflugrath (2008) derive three different report formats from the Guidance Note Report to Australian Standard AUS702, namely, an expanded report, a ‘plain language’ expanded report with the opinion at the end, and a ‘plain language’ report with the opinion at the beginning. The questionnaire-based findings suggest that both more detailed explanation versions of auditor’s reports, for instance regarding responsibilities for the audit, and ‘plain language’ versions appear unsuccessful attempts to narrow the expectation gap. However, re-ordering of report sections may be beneficial.
A third stream of more recent research examines additional – at the time of the respective study not required – information in the auditor’s report. Manson and Zaman (2001) find in their questionnaire-based study that the communication of additional matters in the auditor’s report, for instance corporate governance, is useful for users. They also recommend the disclosure of materiality. Consistent with this recommendation are the findings of the experimental economics studies by Fisher (1990) and Davis (2007). Fisher (1990) documents that materiality disclosure leads to greater market efficiency, with public disclosure being more beneficial than private disclosure. Davis (2007) findings show that the disclosure of materiality enhances investor perception accuracy and, thus, has a positive impact on market efficiency. However, market outcomes are not affected by materiality levels. An international survey of members of the CFA Institute (2010) underpins that materiality information would be useful. In addition, the vast majority of the participants want information on the method of determining materiality. The Houghton et al.’s (2011) findings regarding materiality disclosure are more restrained. They also examine the disclosure of materiality levels by conducting face-to-face office interviews with stakeholder groups. However, there are no conclusive findings whether the actual level of tolerable error, as one aspect of materiality, should be disclosed, because such a disclosure might be misleading. In contrast to the other studies, the CFA Institute (2010) survey also examines stakeholders’ desires for additional information from the auditor. The participants agree that the audit report should contain more information, in particular on the audit process; auditor independence; and the actual level on assurance achieved in the audit. Another survey of the investor members of the Audit Quality Forum working group (2007) supports that additional auditor disclosures would be useful; areas identified in this survey are: more information about emphases of matter, and references to uncertainty and future risk; discussion of material issues identified in the audit and
their resolution; tailored company reports rather than standardized reports; alternative accounting treatments considered and the reasons for adopting the treatment chosen, where material; and more information on material areas of judgment and difficult or sensitive issues. Mock et al. (2013) and Vanstraelen, Schelleman, Meuwissen, and Hofmann (2012) give an overview of the current audit reporting debate and provide insights on users’ information needs. One very recent study by Christensen et al. (2014) examines nonprofessional investors’ reactions – whereby business school graduates are surrogates for nonprofessional investors – to a CAM paragraph\(^4\) related to the audit of fair value estimates. Their findings show that participants who receive a CAM paragraph are more likely to change their investment decision than participants who receive an auditor’s report without a CAM paragraph or who receive the information from the CAM paragraph as part of management’s footnote. Moreover, the effect of the KAM paragraph is mitigated when it is followed by a resolution paragraph containing auditor’s assurance for the CAM.

Taken together there are only few studies that refer to additional – at the time of the respective study not required – disclosures in the auditor’s report whereby the focus is on materiality (Fisher 1990; Manson and Zaman 2001; Davis 2007; CFA Institute 2010; Houghton et al. 2011). Only one very recent study explicitly examines the effect of a CAM paragraph (Christensen et al. 2014). Theoretical work in this area delivers an explanation for that: Previous changes in the auditor’s report – may it be due to the provision of additional information or simply due to wording changes – put the main emphasis on providing more information on generalized audit responsibilities rather

\(^4\) CAM are those matters addressed during the audit that (1) involve the most difficult, subjective, or complex auditor judgments; and/or (2) pose the most difficulty to the auditor in obtaining sufficient appropriate audit evidence; and/or (3) pose the most difficulty to the auditor in forming an opinion on the financial statements (PCAOB 2013). CAM paragraphs reflect the Public Company Accounting Oversight Board’s (PCAOB) implementation of enhancing the auditor’s reporting model in terms of communicating auditor insights to investors about critical audit issues. CAM paragraphs are considered to be conceptually equivalent to KAM paragraphs.
than on audit-specific information, e.g., in terms of auditors’ work and, therefore, on findings of the company which has been audited (Humphrey, Moizer, and Turley 1992; Humphrey, Loft, and Woods 2009). Hence, researchers have no basis for an examination of the potential effect of more information about the auditor’s work on users’ perception. However, researchers argue that additional disclosures in the auditor’s report related to audit findings have the potential to enhance the communicative value of the auditor’s report and, therefore, recommend such disclosures (Manson and Zaman 2001; Church et al. 2008). Surveys of users’ information needs underpin that additional information in the auditor’s report would be useful. The concept of communicating KAM in the auditor’s report implements this thinking as under the new auditor reporting model matters of most significance in the audit have to be disclosed. The identification of the individual KAM and also the communication of KAM, however, are subject to auditor’s professional judgment. Therefore, the disclosure of KAM relates to additional insights into matters that required in particular auditor’s effort – information that is very relevant for users. Thus, the communication of KAM should also be linked to the communicative value of the auditor’s report for the users.

IV. HYPOTHESES DEVELOPMENT

To capture the communicative value of the auditor’s report for users we refer to two dimensions which constitute our dependent variables: the potential to change the user’s assessment of the company’s economic situation, and the user’s confidence in making that assessment. We consider these two dimensions as they directly reflect the main assessments within investment professionals’ analyses and/or investment decisions. We therefore assume that the communicative value of the auditor’s report changes if user’s assessments in either of these two dimensions change. There is scarce
evidence yet on whether the inclusion of a separate KAM section in the auditor’s report is linked to the communicative value of the auditor’s report for users. Beyond the effect that KAM per se potentially have on the communicative value, we believe that the specific tendency of the KAM section has to be addressed, in order to understand how users’ perceive the message conveyed with the KAM section.

This is of particular interest for two reasons. First, the communication of KAM is not standardized, but subject to the circumstances of the audit and the auditor’s professional judgment. This implies differences among KAM sections, e.g. in informational content. Second, as we outline in the following, differences in informational content are likely to trigger different factors in a model of trust in different ways which in turn has the potential to affect our results. Consequently, we differentiate between two manipulations of a KAM section relating to goodwill impairment (derived from an IAASB illustrative auditor’s report). In a first manipulation, we generate a KAM section with a negative tendency regarding the company’s economic situation by formulating the last sentence as follows: “Already small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future”; referred to as KAM negative. In a second manipulation, we generate a KAM section with a positive tendency regarding the company’s economic situation by formulating the last sentence as follows: “Only large changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future”; referred to as KAM positive.5

5 We stay as close as possible to the IAASB wording (IAASB 2013) in phrasing our manipulations (compare original wording in Appendix 1 to the wording of our manipulations in Appendix 2). As compared to the original, we only adjust the last sentence of the KAM section for our manipulations. In order to create a KAM section with a relatively strong negative tendency regarding the company’s economic situation (KAM negative), we add the word “already” to the beginning of the original sentence. As outlined above, in comparison to the KAM negative condition we replace “already small” by “only large” in the KAM positive condition. In order to gain access to the investment professionals, we were compelled to keep the experimental materials as compact as possible, i.e., to minimize the time effort for
In many auditor reporting studies, hypotheses are derived from communications literature and communication models (e.g., Hasan, Roebuck, and Simnett 2003), or from a compilation of prior findings (e.g., Gold et al. 2012). Those studies often argue that changes in wording of a report affect the addressees’ informational basis and thus alter the respective perceptions. Based on prior literature and in line with the IAASB’s implicit objective, with respect to our first dimension of communicative value, we expect that users’ assessment of the company’s economic situation is affected by the specific informational content of the KAM section.

Intuitively, it seems reasonable to expect the users’ assessment of an entity’s economic situation to be more negative if the auditor’s report includes a KAM section with a rather negative tendency as compared to a KAM section with a rather positive tendency.6 Regarding the second dimension of communicative value, i.e. the user’s confidence in the assessment of the company’s economic situation, users should be more confident in their assessment of the company’s economic situation if the auditor’s report includes a KAM section at all – regardless of the specific KAM tendency. That is because the informational basis for users’ assessment becomes larger by the provision of KAM and hence, information asymmetry is reduced in both conditions. However, the provision of directional predictions based on changes of wording is challenging, because the transformation of words into a message is an extremely complex cognitive process (see for example, Fiske 1990).

participants. We therefore could not include manipulation check questions in our main experiment. Instead, we validate our manipulations with individuals from Amazon Mechanical Turk as described in the robustness check section later.

6 Even if the case of no communication of KAM in the auditor’s reports of audits of complete sets of general purpose financial statements for listed entities in the new auditor reporting model should be extremely rare, we need that case as reference case for our analysis. In order to isolate the effect of the specific informational content of the KAM section in our experiment, we further include only one KAM in the auditor’s report.
However, based on the implications of trust literature and a model of trust, which we propose to apply in our study in order to explain the potential effect of a new KAM section in the auditor’s report on the communicative value for users, expectations change. Lewicki, McAllister, and Bies (1998) outline that the understanding why people trust and how trust shapes (social) relations has been a major field of research for disciplines like psychology, sociology, political science, anthropology and economics (see also Worcel 1979; Gambetta 1988; Barber 1983; Ekeh 1974; Axelrod 1984). Furthermore, it is argued that trust is essential for a healthy personality (e. g., Shaver and Hazan 1994), provides a foundation for interpersonal relationships as well as for cooperation (e. g., Rempel, Holmes, and Zanna 1985), and constitutes the basis for stability in social institutions and markets (e. g. Williamson 1974). Definitions of trust are manifold. Earlier definitions focus on individuals’ confidence in other person’s intentions and motives (Mellinger 1956, Read 1962), while more recent research focuses on behavior (Hosmer 1995; Lewicki et al. 1998). Mayer, Davis, and Schoorman (1995, 712) define trust as the “willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party”. Similarly, Currall and Judge (1995, 151) define trust as “an individual’s behavioral reliance on another person under a condition of risk”. Johnson-George and Swap (1982, 1306) suggest that “willingness to take risks may be one of the few characteristics common to all trust situations” and hence, that “there is something of importance to be lost” (Mayer et al. 1995, 712).

An own body of research focuses on understanding and measuring of trust (e. g., Currall and Judge 1995; Cummings and Bromiley 1996; Kramer 1999). Butler (1991) derives a conditions of trust inventory based on a compilation of factors utilized in prior studies (see also Mishra 1996, Sitkin and Roth 1993, who use very similar factors in
their studies). Drawing from those studies, Mayer et al. (1995) propose a model of (organizational) trust which is outlined in Figure 1.

[Insert Figure 1 here]

Based on their model, the authors make three propositions all of which are of importance for our study. First, it is argued that trust for a trustee will be a function of the trustee’s perceived ability, benevolence, and integrity (and also of the trustor’s propensity to trust, which is of minor relevance for our approach). Ability captures the trustee’s competence, benevolence, his or her loyalty, openness, receptivity and availability, and integrity aspects like his or her discreetness and fairness (see Figure 1). Thereby, each factor captures unique elements of trustworthiness. Second, it is proposed that the effect of integrity on trust will be most salient early in the relationship prior to the development of meaningful benevolence data. And third, the effect of perceived benevolence on trust will increase over time as the relationship between parties develops.

According to the model, the level of trust in the trustee will – in combination with the perceived risk of the situation – drive the trustor’s attitude towards risk taking in the relationship with the trustee. Finally, the observation of outcomes in the specific situation of trust (was the trustor in fact trustworthy?) will influence the perceived trustworthiness and might alter the level of trust and consequently the trustor’s attitude towards risk taking in the relationship with the trustee. Trustworthiness also affects, monitors, and guides individuals’ actions and attitudes in their interactions (Kasper-Fuehrera and Ashkanasy 2001). Specifically, perceived trustworthiness reduces suspicion and increases openness toward the trustor (Shinners 2009; Szulanski, Cappetta, and Jensen 2004). Jones (1996, 5) argues, that “to trust someone is to have an attitude of optimism about” that person. Other studies find that trust has a positive effect
on perceived accuracy of information provided (Benton, Gelber, Kelley, and Liebling 1969; Roberts and O’Reilly 1974) and a negative effect on the perceived probability of loss (Nooteboom, Berger, and Noorderhaven 1997). To summarize, “the effects of trust on attitudes and perceptions have been found to be fairly consistent and positive” (Langfred 2004, 385).

Drawing from the outlined conceptions of trust, we argue that the communication between auditor and user based on the auditor’s report constitutes a situation of trust. The users base their investment decisions (in case of investors) or their analyses (in case of financial analysts/investment professionals) on financial statements and auditor’s reports. Users rely on the trustworthiness of financial statement providers and auditors, with their money or reputation being at stake. Decisions and analyses will be driven by perceived assurance provided by the auditor and the (resulting) perceived credibility of the financial statement, or – in other words – by their trustworthiness. Consequently, differences in perceived trustworthiness related to the auditor’s report will also alter the perceived trustworthiness of the financial statements.

In this study, we apply the outlined model of trust to our experimental setting. We argue that the two different KAM sections applied in this study (KAM positive vs. KAM negative) trigger different factors in the model to different degrees and hence lead to unequal levels of trust which the investment professionals associate with the auditor’s report. Furthermore, we argue that this in turn leads to different levels of trust in, i.e., credibility of, the financial statements and, therefore, to a different user’s assessment of the company’s economic situation and different user’s confidence in making that assessment.

Appendix 2 outlines the wording of the KAM section with positive and negative tendency. We expect that the specific differences in informational content mainly
trigger the following drivers of perceived trustworthiness of the trustee (see Figure 1): competence, loyalty, openness, fairness and promise fulfillment. The other drivers being part of the model of trust (receptivity, availability, consistency and discreetness) rather imply direct and/or repetitive interaction between trustee and trustor and therefore do not match our setting very well. However, although we expect differences in the user’s assessment of the company’s economic situation, as well as in the user’s confidence in making that assessment, due to different levels of trust, directional prediction based on theoretical deliberations seem ambitious, not least because the model of trust has not been used in auditor reporting literature.

Therefore, in order to validate our argumentation and the application of the model of trust in the context of our study, as well as to derive directional hypotheses, we conduct an online pioneer experiment with 81 participants (21 accounting students and 60 individuals from Amazon Mechanical Turk). As we expect that the average participant can finish the pioneer experiment within about five minutes, we exclude those participants who worked on the experiment less than 120 seconds, as they clearly did not invest due effort, and end up with a final sample of 52 observations. In this pioneer experiment, we instruct participants to assume that they work as an investment professionals and that their task is to assess the economic situation of a fictitious group – the Alpha Group. We provide participants with background information about the goodwill recognized by the group. The information is very similar to the information

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7 We were compelled to keep the experimental materials as compact as possible, i.e., to minimize the time effort for participants, in order to gain access to the investment professionals. Hence, validating the application of the model of trust with the participants of our main experiment, for example through an additional post experimental questionnaire, was not an option. Instead, we argue that the utilization of accounting students and individuals from Amazon Mechanical Turk was adequate for validation purposes, as the pioneer experiment does not necessarily rely on context-specific knowledge of the participants. The designs of all experiments in this paper meet the requirements for using human subjects in the experimental laboratory at the university where the lead author is located. The use of human subjects was also approved by the institutions where the main experiment with investment professionals was conducted, i.e. German Association of Financial Analysts and CFA Institute.

8 Excluding more participants by setting higher duration thresholds does not change the results of the pioneer experiment substantially.
that we provide in our main experiment which we will describe in detail below (goodwill paragraph within the notes). In comparison to the main experiment, we include further basic explanations related to goodwill impairment in order to facilitate comprehension of the information provided. Participants are then instructed to read additional information which is made available by the auditor (“information provider”) of the Alpha Group. Applying a between-subjects design, participants are thereby randomly either provided with the KAM section with negative or positive tendency (see Appendix 2). Finally, participants are asked to answer a set of 12 questions: 11 questions relate to different drivers of perceived trustworthiness within the model of trust (see Table 1 for details), while we capture the overall level of trust between the information provider and the participant with a final question. We utilize a structural equation model which mirrors the structure of the model of trust (see Figure 1) and analyze our data with smart PLS software (all constructs in the model are specified reflectively).

[Insert Table 1 here]

In a first step, we estimate the structural equation model for the full sample (KAM with negative and KAM with positive tendency) in order to show that the application of the model of trust in the context of KAM communication is adequate. In a second step, in order to carve out the moderating effect of the two different KAM sections on the overall level of trust, we apply a two-step approach. In a first step, we oppose model estimation results for the KAM section with negative (24 observations) and KAM section with positive (28 observations) tendency sample, respectively (group comparison approach in line with, for example, Rigdon, Schumacker, and Wothke 1998). In a second step, we explicitly include moderating effects as product terms into the (full sample) structural equation model (Henseler and Fassott 2010). Table 2
outlines the model estimation results. The explanatory power of the structural equation model is high for all estimations, as we yield an $R^2$ of 0.814/0.891/0.781/0.830/0.829 for the endogenous latent variable “trust” with the full sample/KAM with negative tendency sample/KAM with positive tendency sample/inclusion of moderator tendency of KAM*ability/inclusion of moderator tendency of KAM*integrity. The structural equation and measurement model quality criteria are generally met for all estimations (untabulated).

[Insert Table 2 here]  

For the full sample, effects from the exogenous constructs “ability” and “integrity” on “trust” are positive and significant (path coefficients of 0.179 and 0.626, respectively). Furthermore, we yield higher positive path coefficients from “ability” and “integrity” on “trust” for the KAM with negative tendency sample as compared to the KAM with positive tendency sample. This suggests that the KAM section with negative tendency leads to a significantly higher level of trust in the trustee (auditor) as compared to the KAM section with positive tendency. The inclusion of moderating effects as product terms between a binary variable “tendency of KAM” (KAM with negative tendency = 0; KAM with positive tendency = 1) and the indicators associated with “ability” and “integrity” (the exogenous constructs with significant impact on “trust”) confirms this conclusion, as we yield significantly negative path coefficients for both moderators. Overall, the results of our pioneer experiment confirm our assumption that potential effects of including KAM sections with different informational content into the auditor’s report on the communicative value for users can be explained in light of implications of trust literature and a model of trust. In particular, we have shown that informational content of KAM is relevant. The KAM section indicating a negative tendency regarding the company’s economic situation (KAM negative) leads to a
significantly higher level of trust in the trustee (auditor) as compared to the KAM section indicating a positive tendency regarding the company’s economic situation (KAM positive).

We argue that the KAM section with positive tendency might in fact be ill-perceived as a kind of appeasement given the challenges the auditor had faced during the audit. This would imply, inter alia, lower levels of perceived openness and fairness. On the contrary, a KAM section with negative tendency might be well-perceived as a helpful signal that draws the users’ attention to issues that they had not been aware of before. This would imply, inter alia, higher levels of perceived openness and fairness (and possibly also competence). Consequently, a KAM section with negative tendency leads to a significantly higher level of trust in the trustee (auditor) as compared to a KAM section with positive tendency. Hence, in line with the implications of trust literature, the trustor (user) is less sensitive to risk, less suspicious and more open toward the auditor and associates higher levels of trust with the auditor’s report (see for example, Kim, Ferrin, and Rao 2008; Klein and Shtudiner 2015; Guiso, Sapienza, and Zingales 2008). This leads (1) to a higher perceived trustworthiness of the financial statements and, consequently, (2) in line with the positive effect of trust on attitudes and perceptions of the trustor consistently found in the other mentioned studies, to a better assessment of the company’s economic situation. In addition, it seems reasonable to assume that the user has more confidence in the assessment when he or she is less sensitive to risk, less suspicious, more open, and perceives the KAM section as an information sign that draws the attention to issues that he or she has not been aware of before.

Based on the outlined theoretical implications and the empirical validation of our argumentation, we formally state the following hypotheses:
H1: Users assess the company’s economic situation more positively if the auditor’s report includes a KAM section with a negative tendency compared to a KAM section with a positive tendency.

H2: Users’ confidence in their assessment of the company’s economic situation is higher if the auditor’s report includes a KAM section with a negative tendency compared to a KAM section with a positive tendency.
V. RESEARCH DESIGN

Research Instrument

In order to make our experiment most accessible for participants and to increase the number of participations, we develop a web-based and a paper-and-pencil version of our research instrument. The web-based participants receive an invitation email with a link which opens a browser window with the first page of the experiment. On the first page, participants are instructed to carefully read the introduction on this page before working on the case study. Participants learn that they will be provided with information concerning the Alpha Group and that they will be asked for their assessments related to different economic issues and also for more general questions. Participants are also instructed to base their assessments only on information provided within the case study, that there is no possibility to receive further information concerning the Alpha Group, to work on the case study by themselves and in the given order, and to provide all required answers. Finally, we assure that responses will be analyzed on an aggregate basis and that individual answers and personal information will be treated confidentially and only used for research purposes. By clicking the button “Continue”, participants then access the case itself.

On the second page, all participants receive short background information about the Alpha Group and comprehensive excerpts of the group’s annual report which consist of a consolidated income statement, statement of cash flow, balance sheet, other financial data (for financial years 2011 and 2012, respectively) and notes according to International Financial Reporting Standards (IFRS). In addition, participants receive a full auditor’s report. All information elements are arranged one below the other and participants can scroll up and down to process the excerpts of the Alpha Group’s annual report.
While the Alpha Group itself is fictitious, we are guided by the financial statements of a real German medium-sized group within solar industry in setting up the experimental case. To avoid that our participants recognize the Alpha Group’s real counterpart, we multiply all (balance sheet etc.) items with the same factor and change the industry in which the Alpha Group operates from solar to industrial machinery. In order to allow for meaningful variation in the assessment of the economic situation of the company and the confidence in that assessment, i.e., in order to avoid large proportions of answers on either end of the scales, we decided that the Alpha Group should neither be in financial distress nor economically booming. Therefore, the Alpha Group (as well as its real counterpart) is a financially stable group with a significant decline in profits from 2011 to 2012 (changes in operating income/profit for financial year -93.16 percent/-104.26 percent) driven by, among other things, declining sales revenue (-21.80 percent). We also believe that the decline in profits generally motivates participants to assess the provided information about the Alpha Group in more detail.

As we manipulate a goodwill-related KAM section in the auditor’s report, the goodwill recognized by the Alpha Group as well as the related note is of particular interest for our study. By analyzing the respective balance sheet item and note, participants learn that the Alpha Group recognizes a goodwill with a carrying amount of 5,107 T Euro (26.01 percent of non-current assets/7.32 percent of total assets) and that the goodwill arose when the Beta AG (public limited company) and the Gamma GmbH (limited liability company) were purchased and merged with the Alpha Group. Furthermore, the note contains information about the impairment test procedure in general and states that the findings of the impairment test indicate no need for any impairment (in 2012).
Finally, the auditor’s report is presented to the participants below the other information as part of the extracts of the Alpha Group’s annual report. We apply a between-subjects experimental design in which we manipulate the informational content of a KAM section in the auditor’s report. In the experimental groups we oppose two auditor’s reports with different tendencies of the KAM section (as explained above) based on the goodwill-related KAM example provided in IAASB (2013) (see Appendix 1 for original wording and Appendix 2 for wording of our manipulations). In the control group, participants are presented with the former standard IAS 700 auditor’s report (without KAM section).

At the end of the described second page of the web-based experiment (below the auditor’s report), participants are instructed to click the “Continue” button and to answer the then following questions. They are also informed that they have the possibility to return to the excerpts of the annual report after reading the respective questions by using a “Back” button. The two questions on the third page of the experiment capture our dependent variables and constitute the experimental task. We ask participants to assess the Alpha Group’s economic situation and the confidence in making that assessment on 11-points Likert scales (see Table 3 for questions and endpoints of the scales) – with these two dimensions we capture the communicative value of the auditor’s report as they directly reflect the main assessments within investment professionals’ analyses and/or investment decisions. We therefore assume that the communicative value of the auditor’s report changes if user’s assessments in either of these two dimensions change.

[Insert Table 3 here]

After answering the questions on the third page of the experiment, participants click on “Continue” and open the fourth page, where they are informed that it is not
possible to return to the excerpts of the annual report anymore. Participants are then instructed to rate the relevance of each element of the provided excerpts of the Alpha Group’s annual report (including auditor’s report) for the assessment of the economic situation and to indicate how each of the elements changed their confidence in their assessment on five-points Likert scales (from “not relevant at all”/”high decrease in confidence” to “extremely relevant”/”high increase in confidence”). Finally, we gather demographic information on the fifth page and thank the participants for their participation on the sixth page.

Procedures, instructions and case materials for the paper-and-pencil version of the experiment are identical to the above described (analogously adapted where necessary). While we ensured technically that participants work on the experiment in the described sequence and that revisions of given answers are not possible in the web-based experiment, we split up the case material to two envelopes which have to be opened and sealed in a specific sequence for the paper-and-pencil experiment to implement similar controls.

Participants

We gained access to the CFA Institute (CFA – Certified Financial Analyst) with more than 123,000 members in 145 countries and to the DVFA (German Association of Financial Analysts) with more than 1,400 members in Germany. For the web-based experiment, the invitation email is sent out to a CFA Institute survey pool (with members from all over the world) and to all DVFA members. The paper-and-pencil experiment is conducted during several training sessions at the DVFA headquarters with investment professionals by one of the authors in turn.

We derive 14 participants from the CFA Institute (web-based) and 24/51 participants from the DVFA (web-based/paper-and-pencil) subjects pool (7 more web-
based observations were deleted due to discontinuation of participation), yielding the final sample of 89 participants analyzed below (we do not identify further need to exclude individual observations from the analysis). As outlined in Table 4, the average age of our participants is 37.66 years. 79.75 percent of the participants are male, 82.28 percent of the participants come from Germany, 10.12 percent from the USA, UK or Canada (decreasing order) and 7.60 percent from other countries around the world. 81.40 percent of the participants work as investment professionals for on average 10.53 years. Of those participants working as investment professionals, 26.67 percent are bankers, 21.33 percent are (sell- or buy-side) financial analysts, 18.67 percent are asset managers, 5.33 percent are investment bankers, 5.33 percent are consultants, 4.00 percent are funds managers and 18.67 percent work in none of the outlined professions. Most participants mainly work with equity investments (35.92 percent), corporate bonds (21.36 percent) or sovereign bonds (12.62 percent). Our participants’ experience with personal capital market investments is moderate to considerable (with an average of 3.45 on a 5-points Likert scale, see Table 4 for endpoints).

[Insert Table 4 here]

VI. RESULTS

Descriptive Analysis

Figure 2 outlines the results of our descriptive analysis for the two dependent variables. The excerpts of the annual report of the Alpha Group in combination with the former ISA 700 auditor’s report (control group) lead to a mean user’s assessment of the economic situation of 4.32 and to a mean user’s confidence in this assessment of 6.20 (on 11-points Likert scales; see Table 3 for the respective endpoints of the scales). Hence, participants tend to assess the economic situation of the Alpha Group to be slightly negative and tend to be relatively confident in their assessment. In the KAM
negative experimental group, participants’ assessments of the economic situation are more positive with higher associated confidence in comparison to the control group, leading to means of 5.16 and 6.48, respectively. On the contrary, for the KAM positive experimental group, we find more negative assessments of the economic situation (4.03) with lower associated confidence (6.00) in comparison to the control group. Summarizing, the descriptive analysis suggests that there is a considerable difference in means for both dependent variables between the experimental groups. Furthermore, especially the KAM negative manipulation leads to considerable reactions to that information (see also Table 5).

[Insert Figure 2 and Table 5 here]

For all other variables outlined in Table 5 (relevance of individual elements of the annual report for the assessment of the economic situation and change in confidence due to individual elements) differences in means between groups are small and there is no obvious pattern. In general, the income statement seems to be the most relevant source of information for our participants, followed by the cash flow statement and the balance sheet (across-groups). The relevance of the auditor’s report for the assessment of the economic situation is fairly low for all groups. Interestingly, although not statistically significant, mean assessments for the relevance of the auditor’s report follow the pattern we observe for our dependent variables: the relevance is lowest for the KAM positive and highest for the KAM negative group. This makes sense in light of the theoretical framework we apply, because information can only be relevant if it is trustworthy.

Analysis of Variance

Table 6 outlines the results of the ANOVA applied to analyze the data for the assessment of the company’s economic situation. First, group means for the former ISA
700/KAM positive/KAM negative condition differ significantly ($p = 0.0529$). A post-hoc mean comparison test reveals that the mean user’s assessment of the economic situation of the Alpha Group is significantly more positive in the KAM section with a negative tendency as compared to the KAM section with a positive tendency condition ($p = 0.057/0.063/0.056$ based on Bonferroni/Scheffe/Sidak adjustment of confidence intervals). Hence, we can support our first hypothesis $H_1$. While the descriptive analysis revealed that the user’s confidence in the assessment of the economic situation in the KAM section with a negative tendency as compared to the KAM section with a positive tendency condition is considerably higher – which is in line with our second hypothesis $H_2$ – the difference is non-significant in an ANOVA analysis (untabulated). Hence, the ANOVA does not support the descriptive result.

[Insert Table 6 here]

**Robustness Check**

To validate our findings, we utilize ANCOVA and regression techniques and include diverse covariates and control variables (relevance of/change in confidence due to individual items and demographic variables) for which theory or prior studies suggest an influence. While those analyses confirm the reported findings, we do not yield significant interactions or other results.

Furthermore, we validate our manipulations with 79 individuals from Amazon Mechanical Turk. All considered 79 individuals answered a simple accounting-related question correctly, with which we assure that the participants have a very basic knowledge of the matter.\(^9\) We utilize the design of our pioneer experiment described

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\(^9\) We asked participants to choose the correct ending to the sentence “A company’s equity is equivalent to…” out of three provided options: “…assets minus liabilities” (correct answer), “…current assets plus non-current assets” and “…profit before tax (EBT) minus operating income (EBIT)”. Of originally 100 participants, 21 failed to indicate the correct answer.
above. Instead of the questions outlined there, we ask a set of questions in both KAM conditions (between subjects) which relate to the understanding/perception of the manipulation (random order of questions; see Table 7 for the questions). As can be seen in Table 7, participants’ response pattern suggest that our manipulations were successful. In particular, as intended, the message conveyed with the last sentence of the KAM section (our manipulation) is perceived to be a significantly negative (positive) signal concerning the economic situation of the Alpha Group in the KAM negative (positive) condition. Furthermore, participants’ assessment of the risk that a goodwill impairment will occur is high in the KAM negative and low in the KAM positive condition (means differ significantly from the midpoint “4” of the scale). The results for two other questions (see Table 7 for details) confirm that the manipulations were successful, but are less distinct. Overall, participants’ reaction seems to be more intense in case of the KAM negative as compared to the KAM positive manipulation. This could provide an explanation for the dissimilar magnitude of effects described in the main experiment, but does not harm our findings in any way.

[VII. CONCLUSION]

With the new auditing standard ISA 701, the IAASB has recently introduced a separate section in the auditor’s report of audits of full sets of general purpose financial statements that communicates so-called key audit matters (KAM), i.e., matters that were of most significance in the audit. The intention thereby is to provide users with more information about the auditor’s work and, thus, to enhance the communicative value of the auditor’s report. In this study, we experimentally examine the potential effect of a separate KAM section in the auditor’s report on its communicative value for users. In doing so, we capture the auditor’s report’s communicative value by two dimensions, the
potential different user’s assessment of the company’s economic situation and the user’s confidence in making that assessment as these two dimensions directly reflect the main assessments within investment professionals’ analyses and/or investment decisions. We therefore assume that the communicative value of the auditor’s report changes if user’s assessments in either of these two dimensions change.

Assuming that the specific informational content of the KAM section triggers different factors in a model of trust in different ways – which in turn has the potential to affect our results – we differentiate between two content-related manipulations: (1) A KAM section suggesting that already small changes in the key assumptions could eventually lead to a goodwill impairment (KAM negative). (2) A KAM section suggesting that only large changes in the key assumptions could eventually lead to a goodwill impairment (KAM positive). The control group is provided with the former ISA 700 auditor’s report (without separate KAM section).

We find that in the KAM negative condition, participants assess the economic situation of the company to be significantly better as compared to the KAM positive condition. Correspondingly, the descriptive results indicate that participants’ confidence in their assessment is higher in the KAM negative condition. We interpret the results in the light of a model of trust and conclude that the specific informational content of the KAM section triggers different factors in the model to different degrees, eventually leading to unequal levels of trust which the investment professionals associate with the auditor’s report. This divergence in perceived trustworthiness related to the auditor’s report will then also alter the perceived trustworthiness of the financial statements and hence user’s assessments of the company’s economic situation and the user’s confidence in making that decision. These results suggest that the KAM section with a positive tendency is rather ill-perceived by users as a kind of appeasement given the
challenges the auditor had faced during the audit, while the KAM section with a negative tendency is rather well-perceived as a helpful signal that draws the users’ attention to issues that they had not been aware of before. Thus, neither preparers nor audit committees or auditors need to fear that the disclosure of critical entity-related information leads to negative implications; in contrast, users value this information positively.

This study contributes to the auditor reporting literature in at least three ways. First, it extends the very scarce literature on the potential effect of the KAM section in the auditor’s report on the communicative value for users by using real investment professionals. The participants of our experiment are investment professionals from more than one country which has two main advantages. One, we do not have to refer to surrogates for users, such as graduate accounting students; we rather directly examine the assessment of one of the most important user groups. Two, given that our investment professionals are from more than one country, we believe that our findings are not restricted to a certain jurisdiction. Second, to the best of our knowledge, this is the first study that examines the potential effect of the additional information about KAM in the auditor’s report by considering different tendencies of KAM on the communicative value for investment professionals. Our findings are useful for standard setters and auditors by highlighting the importance of carefully phrasing a KAM section, also considering how users’ perceive the message conveyed with the KAM section. This aspect is highly relevant because the identification and communication of KAM are subject to the auditor’s professional judgment. Third, by referring to a model of trust that theoretically explains why different tendencies of KAM potentially lead to different user’s assessments of aspects related to the communicative value, we employ an innovative approach in the auditor reporting literature not used thus far.
Our study is of course not without limitations. We employ an experimental approach in which we manipulate the informational content of one KAM example in a specific setting. Consequently, our findings mainly depend on our manipulations and the setting. However, it seems reasonable to assume that the KAM example in the IAASB illustrative auditor’s report, from which we carefully derive our manipulations, is of significant practical relevance and may also be used by auditors as a general pattern. Furthermore, based on the implications of the model of trust, it seems reasonable to assume that any KAM section with a (strong) positive or negative tendency bears the risk of possibly unexpected users’ perceptions. Also, unlike many other studies, our study relies on real investment professionals as participants. Accordingly, our findings reflect expert knowledge and experience applied in a relatively realistic scenario. The generalizability of our results might therefore be greater in comparison to many other experimental studies.
REFERENCES


available at:


FIGURES

Figure 1: Model of Trust
Figure 2: Descriptive Results for Dependent Variables

![Graph showing descriptive results for dependent variables.](image-url)
**TABLES**

Table 1: Constructs, Factors, Indicators, and respective Questions in the Pioneer Experiment

<table>
<thead>
<tr>
<th>Construct</th>
<th>Factor</th>
<th>Indicator</th>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ability</td>
<td>Competence</td>
<td>x_{11}</td>
<td>My level of confidence that the information provider is technically competent at the critical elements of his or her job is…</td>
</tr>
<tr>
<td></td>
<td></td>
<td>x_{12}</td>
<td>My level of confidence that the information provider has an acceptable level of understanding of his or her job is…</td>
</tr>
<tr>
<td></td>
<td></td>
<td>x_{13}</td>
<td>My level of confidence that the information provider will be able to do his or her job in an acceptable manner is…</td>
</tr>
<tr>
<td></td>
<td></td>
<td>x_{14}</td>
<td>My level of confidence that the information provider will make well thought out decisions about his or her job is…</td>
</tr>
<tr>
<td>Benevolence</td>
<td>Loyalty</td>
<td>x_{21}</td>
<td>My level of confidence that the information provider is on my side is…</td>
</tr>
<tr>
<td></td>
<td></td>
<td>x_{22}</td>
<td>My level of confidence that the information provider acts in my best interest is…</td>
</tr>
<tr>
<td>Openness</td>
<td></td>
<td>x_{23}</td>
<td>My level of confidence that the information provider shares all known and relevant information about important issues even if there is a possibility that the information might jeopardize my interest in the Alpha Group is…</td>
</tr>
<tr>
<td></td>
<td></td>
<td>x_{24}</td>
<td>My level of confidence that the information provider openly addresses difficulties is…</td>
</tr>
<tr>
<td></td>
<td></td>
<td>x_{25}</td>
<td>My level of confidence that the information provider provides me with precise information is…</td>
</tr>
<tr>
<td>Integrity</td>
<td>Fairness</td>
<td>x_{31}</td>
<td>My level of confidence that the information provider will treat me fairly is…</td>
</tr>
<tr>
<td></td>
<td>Promise</td>
<td>x_{32}</td>
<td>My level of confidence that I can rely on what the information provider tells me is…</td>
</tr>
<tr>
<td>Trust</td>
<td>Trust</td>
<td>y_{11}</td>
<td>The level of trust between the information provider and myself is…</td>
</tr>
</tbody>
</table>

Scale: [nearly zero; very high]
Table 2: Predictors and Path Coefficients in the Pioneer Experiment

<table>
<thead>
<tr>
<th>Criterion Group</th>
<th>Predictors</th>
<th>$R^2$</th>
<th>Path coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trust</td>
<td>Ability</td>
<td>0.814</td>
<td>**0.179</td>
</tr>
<tr>
<td>Full Sample</td>
<td>Benevolence</td>
<td>0.159</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Integrity</td>
<td></td>
<td>***0.626</td>
</tr>
<tr>
<td>Trust</td>
<td>Ability</td>
<td>0.891</td>
<td>*0.264</td>
</tr>
<tr>
<td>KAM Negative</td>
<td>Benevolence</td>
<td>0.098</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Integrity</td>
<td></td>
<td>***0.645</td>
</tr>
<tr>
<td>Trust</td>
<td>Ability</td>
<td>0.781</td>
<td>0.140</td>
</tr>
<tr>
<td>KAM Positive</td>
<td>Benevolence</td>
<td>0.228</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Integrity</td>
<td></td>
<td>**0.570</td>
</tr>
<tr>
<td>Trust</td>
<td>Ability</td>
<td>0.830/0.829</td>
<td>***0.238/ **0.213</td>
</tr>
<tr>
<td>Full Sample</td>
<td>Benevolence</td>
<td>0.142/0.145</td>
<td></td>
</tr>
<tr>
<td>with Moderators</td>
<td>Integrity</td>
<td></td>
<td>***0.609/***0.630</td>
</tr>
<tr>
<td></td>
<td>Moderator Ability</td>
<td></td>
<td>*-0.135/</td>
</tr>
<tr>
<td></td>
<td>Moderator Integrity</td>
<td></td>
<td>/ *-0.127</td>
</tr>
</tbody>
</table>

*** significant at <0.01 level, ** significant at <0.05 level, * significant at <0.10 level (two-tailed tests)
Table 3: Dependent Variables and Questions in the Main Experiment

<table>
<thead>
<tr>
<th>Variable</th>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessment of Economic Situation</td>
<td>How do you assess the economic situation of the Alpha Group based on the provided excerpts of the annual report including the auditor’s report? [extremely negative; extremely positive]</td>
</tr>
<tr>
<td>Confidence in Assessment of Economic Situation</td>
<td>How confident are you in your assessment of the economic situation of the Alpha Group based on the provided excerpts of the annual report including the auditor’s report? [not confident at all; absolutely confident]</td>
</tr>
</tbody>
</table>
Table 4: Demographic Data of Participants in the Main Experiment

<table>
<thead>
<tr>
<th>Variables</th>
<th>Parameter</th>
<th>Category/Scale</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Observations</td>
<td>Count</td>
<td>Total</td>
<td>89</td>
</tr>
<tr>
<td></td>
<td></td>
<td>web-based</td>
<td>38</td>
</tr>
<tr>
<td></td>
<td></td>
<td>paper-and-pencil</td>
<td>51</td>
</tr>
<tr>
<td>Age</td>
<td>Mean</td>
<td>Years</td>
<td>37.66</td>
</tr>
<tr>
<td>Gender</td>
<td>Percentage</td>
<td>Male</td>
<td>79.75</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Female</td>
<td>20.25</td>
</tr>
<tr>
<td>Country of Origin</td>
<td>Percentage</td>
<td>Germany</td>
<td>82.28</td>
</tr>
<tr>
<td></td>
<td></td>
<td>USA, UK, Canada</td>
<td>10.12</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Other</td>
<td>7.60</td>
</tr>
<tr>
<td>Occupation</td>
<td>Percentage</td>
<td>Investment Professional</td>
<td>81.40</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Other</td>
<td>18.60</td>
</tr>
<tr>
<td>Experience as Investment</td>
<td>Mean</td>
<td>Work Years</td>
<td>10.53</td>
</tr>
<tr>
<td>Professional</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Category of Investment</td>
<td>Percentage</td>
<td>Banker</td>
<td>26.67</td>
</tr>
<tr>
<td>Professional</td>
<td></td>
<td>Financial Analyst (sell-/buy-side)</td>
<td>21.33</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Asset Manager</td>
<td>18.67</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Investment Banker</td>
<td>5.33</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Consultant</td>
<td>5.33</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Funds Manager</td>
<td>4.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Other</td>
<td>18.67</td>
</tr>
<tr>
<td>Focus of Activity as</td>
<td>Percentage</td>
<td>Equity</td>
<td>35.92</td>
</tr>
<tr>
<td>Investment Professional</td>
<td></td>
<td>Corporate Bonds</td>
<td>21.36</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Sovereign Bonds</td>
<td>12.62</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Real Estate</td>
<td>4.85</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Money Markets</td>
<td>2.91</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Other</td>
<td>22.34</td>
</tr>
<tr>
<td>Experience with Personal</td>
<td>Mean</td>
<td>[No experience = 1;</td>
<td>3.45</td>
</tr>
<tr>
<td>Capital Market Investments</td>
<td></td>
<td>Extensive Experience = 5]</td>
<td></td>
</tr>
<tr>
<td>Variables</td>
<td>Coding [Endpoints of scale]</td>
<td>Former ISA 700 Mean / SD (Number of Observations)</td>
<td>Group KAM Negative</td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td>-----------------------------</td>
<td>---------------------------------------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>Assessment of Economic Situation</td>
<td>1 - 11 [extremely negative; extremely positive]</td>
<td>4.32 / 1.80 (25)</td>
<td>5.16 / 2.18 (31)</td>
</tr>
<tr>
<td>Confidence in Assessment of Economic Situation</td>
<td>1 - 11 [not confident at all; absolutely confident]</td>
<td>6.20 / 2.65 (25)</td>
<td>6.48 / 2.31 (31)</td>
</tr>
<tr>
<td>Relevance Income Statement for Assessment of Economic Situation</td>
<td></td>
<td>3.73 / 1.12 (26)</td>
<td>4.10 / 0.98 (31)</td>
</tr>
<tr>
<td>Relevance Cash Flow Statement for Assessment of Economic Situation</td>
<td></td>
<td>3.88 / 1.11 (26)</td>
<td>3.94 / 1.09 (31)</td>
</tr>
<tr>
<td>Relevance Balance Sheet for Assessment of Economic Situation</td>
<td>1 – 5 [not relevant at all; extremely relevant]</td>
<td>3.62 / 1.13 (26)</td>
<td>3.71 / 0.97 (31)</td>
</tr>
<tr>
<td>Relevance Other Financial Data for Assessment of Economic Situation</td>
<td></td>
<td>2.96 / 1.22 (26)</td>
<td>2.65 / 1.05 (31)</td>
</tr>
<tr>
<td>Relevance Notes for Assessment of Economic Situation</td>
<td></td>
<td>2.84 / 1.03 (25)</td>
<td>2.87 / 0.85 (31)</td>
</tr>
<tr>
<td>Relevance Auditors’ Report for Assessment of Economic Situation</td>
<td></td>
<td>2.38 / 0.94 (26)</td>
<td>2.61 / 1.20 (31)</td>
</tr>
<tr>
<td>Change Confidence due to Income Statement</td>
<td>1 – 5 [high decrease in conf.; high increase in conf.]</td>
<td>3.23 / 1.03 (26)</td>
<td>3.16 / 1.34 (31)</td>
</tr>
<tr>
<td>Change Confidence due to Cash Flow Statement</td>
<td></td>
<td>3.42 / 0.99 (26)</td>
<td>3.39 / 1.17 (31)</td>
</tr>
<tr>
<td>Change Confidence due to Balance Sheet</td>
<td></td>
<td>3.15 / 0.88 (26)</td>
<td>3.61 / 1.02 (31)</td>
</tr>
<tr>
<td>Change Confidence due to Other Financial Data</td>
<td></td>
<td>3.12 / 0.44 (25)</td>
<td>2.97 / 0.75 (31)</td>
</tr>
<tr>
<td>Change Confidence due to Notes</td>
<td></td>
<td>3.00 / 0.63 (26)</td>
<td>2.80 / 0.89 (30)</td>
</tr>
<tr>
<td>Change Confidence due to Auditors’ Report</td>
<td></td>
<td>3.00 / 0.63 (26)</td>
<td>2.74 / 0.96 (31)</td>
</tr>
</tbody>
</table>
Table 6: Results for the ANOVA (Main Experiment, Variable “Assessment of Economic Situation”)

<table>
<thead>
<tr>
<th>Source</th>
<th>SS</th>
<th>df</th>
<th>MS</th>
<th>F</th>
<th>Prob &gt; F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Between Groups</td>
<td>21.386338</td>
<td>2</td>
<td>10.693169</td>
<td>3.04</td>
<td>0.0529</td>
</tr>
<tr>
<td>Within Groups</td>
<td>298.602298</td>
<td>85</td>
<td>3.51296822</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>319.988636</td>
<td>87</td>
<td>3.6780303</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Bartlett's Test for Equal Variances: 
chi2(2) = 2.9704 \hspace{1cm} \text{Prob > chi2} = 0.226

<table>
<thead>
<tr>
<th>Mean Difference</th>
<th>Former ISA 700</th>
<th>KAM Negative</th>
</tr>
</thead>
<tbody>
<tr>
<td>[Significance Bonferroni/Scheffe/Sidak]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>KAM Negative</td>
<td>0.84129</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>[0.296 / 0.254 / 0.268]</td>
<td></td>
</tr>
<tr>
<td>KAM Positive</td>
<td>-0.28875</td>
<td>-1.13004</td>
</tr>
<tr>
<td></td>
<td>[1.00 / 0.847 / 0.918]</td>
<td>[0.057 / 0.063 / 0.056]</td>
</tr>
</tbody>
</table>
Table 7: Results for the Manipulation Check Experiment

<table>
<thead>
<tr>
<th>Question</th>
<th>KAM negative (41 observations)</th>
<th>KAM positive (38 observations)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>SD</td>
</tr>
<tr>
<td>Is the message conveyed with the last sentence (in boldface) of the information above a positive or a negative signal concerning the economic situation of the Alpha Group? [Very positive; Very negative]</td>
<td>5.05***</td>
<td>1.38</td>
</tr>
<tr>
<td>How do you assess the risk for the Alpha Group that a goodwill impairment will occur? [Very low; Very high]</td>
<td>4.66***</td>
<td>1.24</td>
</tr>
<tr>
<td>How robust is the calculation of the goodwill recognized by the Alpha Group against changes in the underlying assumptions used by management? [Very robust; Not very robust]</td>
<td>4.27</td>
<td>1.45</td>
</tr>
<tr>
<td>A goodwill impairment impacts the Alpha Group’s income… …positively. …negatively. …positively. …negatively.</td>
<td>7</td>
<td>34</td>
</tr>
</tbody>
</table>

***: mean differs from midpoint of the scale at 1%-significance-level (one-tailed t-test)

**: mean differs from midpoint of the scale at 5%-significance-level (one-tailed t-test)
Appendix 1: Illustrative Auditor’s Report (IAASB 2013)

INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addresses]

Report on the Audit of the Consolidated Financial Statements

Opinion

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, (or give a true and fair view of) the consolidated financial position of ABC Company and its subsidiaries (the Group) as at December 31, 20X1, and (of) their consolidated financial performance and their consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

We have audited the consolidated financial statements of the Group, which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Group within the meaning of [indicate relevant ethical requirements or applicable law or regulation] and have fulfilled our other responsibilities under those ethical requirements.

(see Question 11) We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters (see Questions 1-8)

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements. Key audit matters are selected from the matters communicated with [those charged with governance], but are not intended to represent all matters that were discussed with them. Our audit procedures relating to these matters were designed in the context of our audit of the consolidated financial statements as a whole. Our opinion on the consolidated financial statements is not modified with respect to any of the key audit matters described below, and we do not express an opinion on these individual matters.

The four specific topics and content presented below are purely for illustrative purposes. This section would be tailored to the facts and circumstances of the individual audit engagement and the entity. Accordingly, the IAASB has intentionally drafted these examples in a manner that indicates that Key Audit Matters will vary in terms of the number and selection of topics addressed and the nature in which they may be described, and are intended to be consistent with the disclosures in the entity’s consolidated financial statements.

Goodwill

Under IFRSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test is significant to our audit because the assessment process is complex and highly judgmental and is based on assumptions that are affected by expected future market or economic conditions, particularly those in [Countries X and Y]. As a result, our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the

3 The sub-title “Report on the Audit of the Consolidated Financial Statements” is unnecessary in circumstances when the second sub-title “Report on Other Legal and Regulatory Requirements” is not applicable.
forecasted revenue growth and profit margins for [name of business lines]. We also focused on the adequacy of the Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill. The Group's disclosures about goodwill are included in Note 3, which specifically explains that small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future.

Valuation of Financial Instruments

The Group's disclosures about its structured financial instruments are included in Note 5. The Group's investments in structured financial instruments represent [ ]% of the total amount of its financial instruments. Because the valuation of the Group's structured financial instruments is not based on quoted prices in active markets, there is significant measurement uncertainty involved in this valuation. As a result, the valuation of these instruments was significant to our audit. The Group has determined it is necessary to use an entity-developed model to value these instruments, due to their unique structure and terms. We challenged management's rationale for using an entity-developed model, and discussed this with [those charged with governance], and we concluded the use of such a model was appropriate. Our audit procedures also included, among others, testing management's controls related to the development and calibration of the model and confirming that management had determined it was not necessary to make any adjustments to the output of the model to reflect the assumptions that marketplace participants would use in similar circumstances.

Acquisition of XYZ Business

As described in Note 2, in December 20X1, the Group completed the acquisition of XYZ Business. XYZ Business was a division of a large private company. As of December 31, 20X1, the Group has completed the initial acquisition accounting on a preliminary basis. The Group will finalize the initial acquisition accounting during 20X2, and the amounts recorded as of December 31, 20X1 could change. We focused on this transaction because it is material to the consolidated financial statements as a whole and the fact that values had not previously been assigned to the division as a standalone operation. In addition, determining the assumptions that underlie the initial acquisition accounting and the useful lives associated with the acquired intangible assets involves significant management judgment given the nature of the [name of industry].

Revenue Recognition Relating to Long-Term Contracts

The terms and conditions of the Group's long-term contracts in its [name of segment] affect the revenue that the Group recognizes in a period, and the revenue from such contracts represents a material amount of the Group's total revenue. The process to measure the amount of revenue to recognize in the [name of industry], including the determination of the appropriate timing of recognition, involves significant management judgment. We identified revenue recognition of long-term contracts as a significant risk requiring special audit consideration. This is because side agreements may exist that effectively amend the original contracts, and such side agreements may be inadvertently unrecorded or deliberately concealed and therefore present a risk of material misstatement due to fraud. In addition to testing the controls the Group has put in place over its process to enter into and record long-term contracts and other audit procedures, we considered it necessary to confirm the terms of these contracts directly with customers and testing journal entries made by management related to revenue recognition. Based on the audit procedures performed, we did not find evidence of the existence of side agreements. The Group's disclosures about revenue recognition are included in the summary of significant accounting policies in Note 1, as well as Note 4.
Going Concern (see Questions 9-10)

The consolidated financial statements of the Group have been prepared using the going concern basis of accounting. The use of this basis of accounting is appropriate unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so. As part of our audit of the consolidated financial statements, we have concluded that management’s use of the going concern basis of accounting in the preparation of the Group’s consolidated financial statements is appropriate.

Management has not identified a material uncertainty that may cast significant doubt on the Group’s ability to continue as a going concern, and accordingly none is disclosed in the consolidated financial statements of the Group. Based on our audit of the consolidated financial statements of the Group, we also have not identified such a material uncertainty. However, neither management nor the auditor can guarantee the Group’s ability to continue as a going concern.

Other Information
[The illustrative wording for this section is subject to the IAASB’s finalization of proposed ISA 720 (Revised). The content of this section may include, among other matters: (a) a description of the auditor’s responsibilities with respect to other information; (b) identification of the document(s) available at the date of the auditor’s report that contain the other information to which the auditor’s responsibilities apply; (c) a statement addressing the outcome of the auditor’s work on the other information; and (d) a statement that the auditor has not audited or reviewed the other information and, accordingly, does not express an audit opinion or a review conclusion on it.]

Responsibilities of [Management* and Those Charged with Governance or other appropriate terms] for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with IFRSs,* and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error. [Those charged with governance] are responsible for overseeing the Group’s financial reporting process. (see Question 13)

Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements (see Question 13)

The objectives of our audit are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

The remaining material in this section can be located in an Appendix to the auditor’s report (see paragraph 39 of proposed ISA 700 (Revised). When law, regulation or national auditing standards expressly permits, reference can be made to a website of an appropriate authority that contains the description of the auditor’s responsibilities, rather than including this material in the auditor’s report (see paragraph 40 of proposed ISA 700 (Revised)).

* Throughout the illustrative auditor’s reports in the Proposed ISAs, the term management may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction. For example, those charged with governance, rather than management, may have these responsibilities.

** Where management’s responsibility is to prepare financial statements that give a true and fair view, this may read: **Management is responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with IFRS, and for such...**
As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control.\(^a\)
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities and business activities within the group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We are required to communicate with [those charged with governance] regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We are also required to provide [those charged with governance] with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

**Report on Other Legal and Regulatory Requirements**

[The form and content of this section of the auditor’s report would vary depending on the nature of the auditor’s other reporting responsibilities prescribed by local law, regulation, or national auditing standards. Depending on the matters addressed by other law, regulation or national auditing standards, national standard setters may choose to combine reporting on these matters with reporting as required by the ISAs (shown in the Report on the Audit of the Consolidated Financial Statements section), with wording in the auditor’s report that clearly distinguishes between reporting required by the ISAs and other reporting required by law or regulation. (see Question 13)]

The engagement partner responsible for the audit resulting in this independent auditor’s report is [name]. (see Question 12)

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

\(^a\) This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements.
Appendix 2

Wording of the auditor’s report used for the ISA 700

[KAM negative/KAM positive] group

[Format differs from case material; accentuation for illustration purposes only]

INDEPENDENT AUDITOR’S REPORT

[Appropriate Addressee]

Report on the Financial Statements
We have audited the accompanying financial statements of the Alpha Group, which comprise the statement of financial position as at December 31, 2012, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management’s Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor’s Responsibility
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the financial statements present fairly, in all material respects, the financial position of Alpha Group as at December 31, 2012, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.
Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements. Key audit matters are selected from the matters communicated with those charged with governance, but are not intended to represent all matters that were discussed with them. Our audit procedures relating to these matters were designed in the context of our audit of the consolidated financial statements as a whole. Our opinion on the consolidated financial statements is not modified with respect to any of the key audit matters described below, and we do not express an opinion on these individual matters.

Goodwill

Under IFRSs, the Alpha Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the assessment process is complex and highly judgmental and is based on assumptions that are affected by expected future market or economic conditions, particularly those in Europe. As a result, our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Alpha Group, in particular those relating to the forecasted revenue growth and profit margins for the cash generating units Beta AG and Gamma GmbH. We also focused on the adequacy of the Alpha Group’s disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill.

[KAM negative]

Already small changes in the key assumptions used (see Alpha Group’s disclosures about goodwill in Note 1) could give rise to an impairment of the goodwill balance in the future.

[KAM positive]

Only large changes in the key assumptions used (see Alpha Group’s disclosures about goodwill in Note 1) could give rise to an impairment of the goodwill balance in the future.

[Auditor’s signature]
[Date of the auditor’s report]
[Auditor’s address]