

INVESTIGATION 4

Future Research

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Introduction

This is the fourth report in the project considering the value of public audit. Investigations 1 and 2 drew heavily on academic literature to consider the value of auditing in general and public audit in particular. While investigation 2 provided examples of how Supreme Audit Institutions (SAIs) report on the public value they deliver, Investigation 3 specifically considered a broad range of activities and reports from the Office of the Auditor General (OAG). During this research, no external parties were interviewed, limiting the conclusions that may be made.

The prior investigations have analysed the value of public audit both in theoretical terms and the way in which value is reported and discharged through reports and actions of the OAG. The research has made a number of recommendations, and some of these imply further research could be undertaken, especially to include the views of stakeholders who are external to the OAG. Accordingly, this investigation is an analysis of whether it is useful to obtain further information by way of interviews or surveys of users and other parties, or by archival examination of reports.

Any of four different projects could be worthwhile to undertake with an overarching push to understand external stakeholders' views on the value of public audit, especially given the environment in which it is carried out is changing. The following section presents the research questions and suggested methodologies. These methodologies are necessarily broad and varied, given the nature of the questions asked. They provide an indication only and would benefit from further discussion and refinement should the research be of interest to take forward.

Suggested research

1. Specific issues relating to audit reports:
 - a. The impact of modified audit reports on decision-makers
 - b. Whether readers seek a specific attestation about internal controls (or not)
2. Testing how the confirmation hypothesis applies to the public sector in terms of whether the unaudited budget is confirmed by the audited actual results.
3. Measures of public trust and confidence that are useful for the OAG
4. Which hypotheses/explanations for audit will drive the future of public audit in delivering value?

In the next section we provide further detail, including the issue the research is intended to shed light on and why the research is necessary. These provide a range of options, and in accordance with the initial plan one or more of these could be selected for further research.

Suggested Research

1. Specific issues relating to audit reports

In this section, two projects are suggested that consider audit reports. These are:

- a. The impact of modified audit reports on decision-makers
- b. Whether readers seek a specific attestation about internal controls (or not)

Following the rationale for recommending this research, suggested methodologies are provided.

Question 1a: The impact of modified audit reports on decision-makers

The problem here is the overall issue examined in this project, namely what is the value of audits in the public sector to users? An important element of this question is what effect do modified opinions have on users' decisions. If they have little or no effect, this implies that audits have a quite limited value. It is therefore useful to find out to what extent modified opinions affect stakeholders.

This issue is parallel to one investigated by a group of IAASB projects. In 2006 the IAASB and the Auditing Standards Board of the American Institute of Certified Public Accountants (2006) commissioned academic research to gather insights on user perceptions regarding the financial statement audit and the auditor's report. This resulted in four commissioned research studies which used experiments (Asare & Wright, 2009; Gold, Gronewold, & Pott, 2009; Porter, Baskerville, & Ó Hógartaigh, 2009), verbal protocol analysis and focus groups (Mock, Turner, Gray, & Coram, 2009), and comparative surveys (Porter et al., 2009). The findings of these research projects are relevant to the first recommended research project – analysis of users' needs with respect to the audit report.

Mock et al. (2009) found that the users in their focus groups were unlikely to read the audit report; indeed, while analysts were unusual in this respect, they noted that they glanced at the audit report to establish which firm had undertaken it and whether or not it was unqualified.¹ Further, the verbal protocol analysis undertaken as part of Mock et al.'s (2009) research confirmed that, even when analysts were unable to sight the audit report, they still made

¹ The groups participating in their focus groups were: (1) CFOs who prepare financial statements that are subsequently audited, (2) bank lenders who use audited financial statements to support loan applications, (3) financial analysts who use audited financial statements to provide investment advice, (4) non-professional investors, and (5) auditors who audit financial statements (Mock et al., 2009, p. 2).

decisions about investing/providing investment advice that were congruent with their actions when the audit report was available.

In further recent analysis of the audit report, Gold et al. (2009) undertook an experiment with auditors, analysts and business students to ascertain whether the new wording proposed under ISA 700 *The Auditor's Report on Financial Statements*, changed their opinion of audit scope and who was responsible for the financial statements. They found that analysts and business students (standing in for naïve investors) did not change their views of these matters, despite wording changes and appeared to draw more on their prior understanding than new wording. Porter et al. (2009), who also undertook an experiment (but with MBA students, rather than a mixed group) to augment the survey findings (see below) also found that the wording of the audit report did not significantly influence users' understandings.

Asare and Wright (2009), who undertook an experiment with 'average investors', auditors and lenders using the wording in the US-based SAS No. 58, also found that these users based decisions on prior understanding, invoking 'reader-response theory' to explain that the context also matters. In their study, auditors' responses were significantly different than average investors and lenders, with auditors being more likely to correctly assess the scope of the audit (Asare & Wright, 2009). While these and other studies have obtained information about user needs in the private sector, the impact of modified audit opinions in the public sector is likely to be different because of the wider range of stakeholders, and the often indirect impact on them of public sector entities.

Specifically, in respect of modified audits, Paananen (2016) reports recent research into the likelihood of municipal authorities' audit reports being modified. Yet, users' needs and responses to such reports is not recorded. Therefore, a study could examine what impact modified audit opinions on the financial statements of public sector entities have. While modified opinions are not common, they do occur, and it is not clear without conducting an investigation whether stakeholders are aware of their significance. Thus, extending research in this area could be worthwhile.

1 (b): Whether readers seek a specific attestation about internal controls

The problem to be investigated is, whether further value would be obtained from reporting on internal controls by management and attestation of these reports by the auditors. Such a requirement has been adopted for large public companies in some countries (e.g., the US, Japan

and China), and researchers have suggested this kind of reporting is particularly appropriate for the public sector (Bedard & Graham, 2014). In addition, following their survey of auditors, auditee, financial community and non-financial community groups in the UK and New Zealand, Porter et al. (2009) confirmed that the largest reason for the audit-expectation gap was the reasonableness gap (52% and 50% respectively). That is, rather than deficient performance (3% and 7% respectively) or deficient standards (45% and 43% respectively), the incorrect ascription of responsibility for audit and misunderstanding of the scope are due to unreasonable assumptions (recognising that standards are also an important factor). One of the recommendations of their research was that users wanted information about internal controls (Porter et al., 2009). This issue of reporting on internal control could now arise in certain circumstances as a result of (ISA) 701: *Communicating Key Audit Matters in the Independent Auditor's Report* (International Auditing and Assurance Standards Board, 2012), although that standard does not deal directly with the issue.

The persistence of the audit-expectation gap in the for-profit space has not deterred the crafting of new standards to address the deficient standards gap, and the operation of regulation has reduced the deficient performance gap (Porter et al., 2009). Nevertheless, there is very little public sector research in this space. Similar issues to those for modified opinions relate to the issue on attestation on internal controls.

ISSAI 9110 *Guidance for Effectiveness of Internal Controls: SAI Experiences* (INTOSAI, 1997) provides examples of how internal controls are reported, but this is outdated and does not respond to the changes in ISA 701. We recognise that the OAG reports on internal controls to underpin the Whole of Government accounts and also to Select Committees, but there is no specific reporting to users of annual reports.

Suggested methodology

Research approaches could include focus groups, and experiments. The focus groups could present different types of audit reports to stakeholders and elicit their reaction. The experiments could include giving financial statement information to groups of respondents. Some respondents would see an unmodified audit opinion, and some a modified audit opinion. They can then be asked for their opinion, or to make a decision. And the same approach, with appropriate adaptations, could be applied to the question about internal control reporting. For this second issue of internal control reporting, focus groups of stakeholders who are frequently

involved in examining public sector information, such as Select Committee members or news media might also be appropriate. This suggested research extends the other investigations, especially Investigation 1, and will gain further understanding by doing so.

2. Testing the confirmation hypothesis.

Problem: It appeared from Investigations 1 and 3 that the confirmation hypothesis might be applicable to the public sector. Users rely on unaudited announcements because they the announcements are backed up by audited financial statements later on (Ball, Jayaraman, & Shivakumar, 2012). While Cordery and Hay (2016) did not find evidence that the confirmation hypothesis is tested in practice in their research for the three SAI reports used for Investigation 2, it would be useful to know if this is the case in the public sector. Unlike the financial market examples that Ball et al. (2012) were referring to, there are unlikely to be analysts who would draw attention to any discrepancy between earlier announcements (such as the annual budget) and audited results. Since the news media do not appear to check unaudited announcements against later audited information, it could be a valuable part of public auditing to check such announcements against audited financial statements. We noted in Investigation 3 that we had observed future earnings being indicated to Select Committee hearings and queried whether this was checked once the results were finalised. We further noted discrepancies in May budget estimates and the annual results in the end of year reports. We also noted local government bodies making announcements of unaudited annual surplus. Local authorities also announce highly summarised accounting information, such as pie charts of expenditure categories to inform ratepayers of how their rates are to be used. This is another use of unaudited information, which under the confirmation hypothesis is reasonable so long as it is confirmed later. These stakeholders are likely to assume that any such information is audited, or that it is confirmed by a separate audit of the financial statements.

As the users of this unaudited information believe it to be reliable, if this is not the case it could reduce the credibility of the OAG. It could be that a response is required if entities release poor quality information. There is very little evidence about the confirmation hypothesis in either the private sector or the public sector. What evidence there is, is in the private sector setting of announcements to financial markets, and the public sector setting has distinct differences.

Suggested Methodology

Research approaches could include interviews, focus groups with selected important users, for example, Select Committee members and/or the media. In addition, research into local government users' (i.e. ratepayers) understanding of summary performance or expenditure information to ascertain whether they check that this information is confirmed, or believe that indeed it was audited in the first place. We note that the Financial Markets Authority (FMA)

has recently surveyed Kiwi Saver investors on their use of their providers' annual reports,² and a survey such as this could be useful. Alternatively, an experiment with different potential users to check the value of the audit of such information, would be useful.

² See <https://fma.govt.nz/assets/Reports/160705-FMA-Kiwisaver-Statements-survey-2016.pdf>

3. What measures of public trust and confidence are useful for the OAG?

Another problem: The research conducted to date has outlined the shortcomings in the proxy used by the OAG in measuring how it contributes to a “Trusted Public Sector” through the State Services Commission (2015) Kiwis Count Survey; how it omits the public’s experience with local government (Institute for Governance and Policy Studies, 2016 (IGPS)) and how it is difficult to distinguish between the improvements that can be attributed to the OAG and those attributable to other factors, respondents’ perceptions of politicians (local and national), and other factors within the economy that may affect the results. The Kiwis Count Survey is very positive (“The 2015 results show New Zealanders have high trust in their public services and their trust and satisfaction continues to grow.”) In contrast, the IGPS study finds that “Our findings suggest that there are serious concerns with levels of public trust in the country.” The World Values Survey used by the OECD is developing its base survey (currently used by the OECD and which informs the Kiwis Count Survey) to more effectively measure trust in government.³ We also noted mixed responses to the Citizen Panel which analysed how public sector entities transfer information to the public. It is apparent that there is the opportunity to more closely research appropriate measures of trust for the OAG to use that cover the range of entities it audits and its contribution to New Zealand society.

Suggested Methodology

It might be useful to find out more about this issue. A survey, perhaps using a commercial research organisation to find respondents, might be a useful approach. Alternatively, liaising with the OECD or other SAIs to develop new specific measures of trust and confidence, would be useful. Close collaboration with the State Services Commission and other interested parties would be recommended. The methodology of this part of the study will require specialist expertise to develop.

³ As noted in <http://www.worldvaluessurvey.org/WVSContents.jsp>. The outcome is expected in July 2016.

4. Which hypotheses/explanations for audit will drive the future of public audit in delivering value?

Investigation 1 suggested a number of explanations for audit in the public sector to be of value, including: agency/ monitoring, information/ signalling, insurance, organizational control, confirmation hypothesis, and risk management (Hay, Simpkins, & Cordery, 2016). Investigations 2 and 3 extended these hypotheses and tested them against published information and aligned them to stakeholders in the public audit process. In summary, we argued that:

- Management will seek audit due to agency theory, information/signalling, insurance explanation and organizational control (and receive management letters, to satisfy this). They also utilise the insurance explanation, the confirmation hypothesis (through the audited annual report), and the risk management and corporate governance explanation (through the operation of an audit committee/independent directors).
- Parliament and Government will seek audit due to agency theory, organizational control and the confirmation hypothesis (and Select Committees receive management letters, audited annual reports and other reports, including performance reports). They also utilise the insurance explanation. Further, the risk management and corporate governance explanation (through the operation of an audit committee/independent directors) appears to be useful.
- Voters and the public (including media) will seek audit due to agency theory and the confirmation hypothesis (and can access reports to Parliament as well as the audited annual reports and performance reports). The lack of scandals suggests the information/signalling explanation for public audit. They also utilise the insurance hypothesis, as well as risk management and corporate governance (this latter being shown by the operation of an audit committee/independent directors).

The explanations for audit may well be subject to change as the environment for audit changes. This should drive the focus of future audit activity and reporting. However, not only has there been little prior research in analysing the explanations for audit in the public sector, but there has been no testing of the prioritisation of audit focus.

Understanding what it is that is valued about the audit is important at the stage of audit planning, to ensure the audit provides value to the users. Audits will vary to the extent that different stakeholders are important. Further, in the changing environment, users' expectations are also changing and therefore it is important to understand these. Investigation 1 provides a thorough

review of these issues, but it has the limitation that it did not collect much information directly from stakeholders.

Suggested Methodology

This investigation is quite wide ranging. The appropriate approach could consist of discussion with focus groups of a wide range of users and other stakeholders. It may be useful to conduct these focus groups with support from specialist researchers. It is envisaged that these focus groups would undertake a priority setting exercise given certain criteria.

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