The Effects of an Explicit Clarification of Auditor Independence on Equity Analysts' Confidence in Financial Reporting and Stock Recommendations

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The Public Company Accounting Oversight Board (PCAOB) recently adopted changes to the auditor's report to make it more informative and relevant to the public (PCAOB, 2017). One such change is the addition of a statement that explicitly clarifies the auditor's independence. Our study uses 123 equity analysts, recruited through Qualtrics, and a 2 × 2 between-subjects experimental design, to investigate whether clarification of auditor independence makes any difference to equity analysts' judgments and confidence in financial reporting. Findings suggest that explicit clarification of auditor independence statement positively impacts analysts' confidence in financial reporting and judgments.

INTRODUCTION

In June 2017, the Public Company Accounting Oversight Board (PCAOB) adopted changes to the standard auditor's report (SAR) following public complaints over the inadequacies of the then existing report (PCAOB, 2017). One change ushered in by the new standard, AS 3101, is the inclusion of an explicit clarification of the auditor's independence statement in the report. The PCAOB believes that "the independence statement in the auditor's report will both enhance investors' and other financial statement users' understanding of the auditor's existing obligations to be independent, and serve as a reminder to auditors of these obligations" (PCAOB, 2017, p.50).

Our research investigates whether requiring auditors to explicitly state in the auditor's report that they are independent of their audit client enhances the perception of auditor independence. We also investigate the impact the addition of explicit clarification statement would have on equity analysts' confidence in the financial reporting process, and how the confidence would affect stock recommendations.

Unquestionably, the auditor's report is the primary means by which the auditor communicates with investors and other financial statement users (PCAOB, 2013). Prior research has shown that an audit report adds credibility to a company's financial statements and facilitates stakeholders' decisions (Coram, Mock, Turner, & Gray, 2011; Doty, 2011). As a result, standard setters, regulators, and investors have a responsibility in ensuring that there are no gaps between what is intended to be communicated by the

auditor and what is encoded by users, because gaps may undermine confidence in the report, lead to poor decisions, and trigger unnecessary litigations (Asare & Wright, 2012b). Thus, the newly adopted Auditing Standard titled *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (AS, 3101) requires auditors to explicitly clarify in the body of the audit report that they are independent of the firm they audit in order to remove all lingering doubts about the auditor's independence. The motivation for our study is to empirically examine what investors make of the claim by the PCAOB that clarification of auditor independence will enhance users' perceptions about the auditor's independence, thus making the report more reliable.

The attention and resources that the PCAOB has poured into modifying the auditor's report are direct consequences of corporate scandals (Lopez, Vandervelde, & Wu, 2009). The scandals forced Congress to pass the Sarbanes-Oxley Act in 2002, and to establish an oversight board (PCAOB) to regulate publicly traded entities. To effectively regulate public entities, the PCAOB adopted Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial* Statements (PCAOB Release 2004-001), and Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements* (PCAOB Release No. 2007-005). These standards have modified the system of audit disclosures by requiring auditors not only to attest to the financial statements, but also to opine on the financial reporting process, including the system of internal controls. Thus, the Act has substantially changed the information environment of public companies with respect to their system of internal controls (Lopez, et. al., 2009).

Another area of inquiry is to investigate whether there is any significant relationship between explicit clarification of auditor independence and type of internal control report. Extant literature suggests that auditors who defy conventional norms to issue adverse internal control opinions are those who are truly independent (Zhang, Zhou, & Zhou, 2007; Domnisoru & Vinatoru, 2008). An adverse internal control opinion indicates that material or significant weaknesses (a control deficiency which presents a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis, PCAOB, 2007) are present in the internal controls. What we do not know is whether an explicit clarification of auditor independence statement will have any significant impact on analysts' perceptions of the effectiveness of internal controls, and assuage their concerns regarding the reliability of financial statements. This is the gap this paper seeks to fill.

It is important to understand how users of financial reports link internal controls over financial reporting to confidence in audit reports, and provide evidence on whether confidence in audit reports is relevant to investment analysis. In other words, it is important to establish whether confidence in the audit report is decision-relevant and any potential interdependencies exist between audit reports and internal control reports.

This study makes two major contributions to the literature. First, the study adds to the literature by establishing that the addition of explicit clarification of auditor independence statement to the auditor's report enhances the value of the report. A prior study by Chen (2014) which used bank loan officers as participants, failed to establish any statistically significant relationship between explicit clarification of auditor independence and confidence in financial reporting. To the contrary, the findings of our research suggest that an explicit clarification of auditor independence in the auditor's report is persuasive enough to enhance users' confidence in financial reports. Secondly, by explicitly clarifying the auditor's obligations to be independent of their client, the misperceptions some users of financial reports have about auditor independence are mitigated, because the added statement assures users that auditors understand their obligations to be independent. Research suggests that additional information disclosures are helpful to analysts because such disclosures add some degree of credibility and transparency to the audit process (Manson & Zaman, 2001; Davis, 2007).

The rest of the paper is structured as follows: literature review and hypotheses, methodology, results, discussion and conclusions.

LITERATURE REVIEW AND HYPOTHESES

Background and Literature Review

Audited financial statements and related disclosures are a critical source of information to analysts who make investment-related decisions. The efficiency of global markets and the well-being of the investing public depend on the quality, comparability and reliability of the information provided by audited financial statements and the accompanying notes. In the newly adopted auditing standard, AS 3101, the Public Company Accounting Oversight Board (PCAOB) posits that the auditor's report is the principal channel by which the auditor communicates with investors and other users of financial statements information regarding the audit of the financial statements (PCAOB, 2013, 2017). The auditor's report plays a pivotal role as a source of needed financial information to so many users, particularly bankers and financial analysts. It is no accident that during the past decade, regulators and standard setters have been contemplating changing the format of the report to align it with the perceived expectations and information needs of the key stakeholders.

The literature on the content and format of the auditor's report has produced mixed findings. Some prior archival studies have documented that the discovery of a weakness in the system of internal controls is value-relevant (Ashbaugh-Skaife, Collins, & Kinney, 2007; Beneish, Billings, & Hodder, 2008; Hammersley, Myers, & Shakespeare, 2008). Furthermore, using an experimental approach with bank loan officers as participants, Schneider & Church (2008) conclude that disclosure of internal control deficiencies is value-relevant to users. However, Whisenant, Sankaraguryswamy, & Raghunandan (2003) find that internal control news is not informative as indicated by the lack of a significant market reaction. Also, the literature suggests that there is a direct relationship between disclosure of ineffective internal controls and lower firm value (Hammersley, et. al., 2008). Some other researchers opine that only independent auditors are capable of issuing adverse internal control audit report (Zhang, et. al., 2007; Dommisoru & Vinatoru, 2008). The argument underlying this line of thinking is that an adverse internal control report will undoubtedly incur the displeasure of management of the company. Hence, the audit firm could lose the engagement. However, contrary to expectations, an adverse internal control audit report, which is perceived as auditor toughness, could increase confidence in the audit report by enhancing users' perceptions of auditor independence. This situation would be at variance with expectancy violation theory which states that violation of expectations leads to counterfactual reasoning and may undermine confidence (Sanna & Turley, 1996).

Explicit Clarification of Auditor Independence and Hypotheses

While the concept of auditor independence is not a new phenomenon, requiring auditors to explicitly state the statement regarding auditor's independence in the standard audit report is a new addition. Until the PCAOB's Concept Release of 2011, and the Proposed Auditing Standards of 2013, the only place the word 'independent' appeared in an audit report was in the title of the report (PCAOB, 2011, 2013). As a result, only Chen (2014) deals directly with clarification of auditor independence as adopted in PCAOB (2017). However, Chen (2014) did not find any significant relationship between explicit clarification of auditor independence and confidence in financial reporting. Arguing on how other clarification phrases (reasonable assurance; present fairly, etc.) would impact audit practice, Glover & Reidenbach (2012) posit that it is possible the phrases may improve investors' understanding of the audit as suggested by the PCAOB, or the additional phrases may adversely impact audit practice by confusing investors via information overload resulting from cluttering the audit report.

Auditor independence (actual or perceived) is seen as the cornerstone of public accounting. As a result, many studies have been conducted regarding auditor independence. Lavin & Libby (1977) investigate the perceptions of auditor independence, using bank loan officers, financial statement analysts, and CPAs as participants. Their results suggest that it is imperative for auditors to be seen by the public as independent professionals. Imhoff (1988) on the other hand, concludes that CPAs and users of financial statements perceive auditor independence differently. The findings of studies by Beck, Frecks, & Solomon (1988), Magee and Tseng (1990) show that perception of auditor independence is threatened by

economic bonding between client and auditor. This explains why Pandit & Rubenfield (2011) caution researchers and regulators to focus on how the overall economic ties between the auditor and the audit client is viewed by analysts and other users of financial reports, since any conflict of interest situation is perceived as a threat to auditor independence.

Explicit clarification of auditor independence in the body of the audit report is a new concept, but it reinforces a long-held belief that independence is the cornerstone of the accounting profession. Both the American Institute of Certified Public Accountants (AICPA) and the U.S. Securities and Exchange Commission (SEC) rules differentiate independence in appearance (the auditor's behavior as seen by the public) from independence in fact (the auditor possesses an independent mind and attitude to perform an audit), but independence in fact is unobservable (Dopuch, King, & Schwartz, 2003). This means that analysts' and other users' judgments about auditor independence are based solely on appearance. Like all human endeavors, there are perceptions and misperceptions of independence. Orren (1997) sums up the concept of auditor independence by observing that because of misperceptions, there are several instances where auditors are actually independent, but the public perceives they are not, or where auditors lack independence, but the public thinks they are independent.

Given the enormous inaccuracies in perceptions of auditor independence, adding a statement in the auditor's report will constantly remind auditors of the need to be independent of their client. This will encourage auditors to shun any behavior and practices that can impair independence in appearance, such as gifts and purchase discount arrangements (Pany & Reckers ,1988), provision of non-audit services to an audit client (Bakar, Rahman, & Rashid, 2005; Bartlet, 1993; Gul, 1989; Knapp, 1985; Shockly, 1981; Teo & Lim, 1996), and be mindful of the size of audit fees or client size (Bartlet, 1993; Gul & Tsui, 1992).

The contention of the PCAOB is that explicitly clarifying auditor independence in the body of an audit report will enhance users' understanding of the auditor's obligations relating to independence, and serve as a reminder to auditors of these obligations. This reasoning by the PCAOB seems to be based on source credibility theory because auditors are seen as a third-party credible source of unbiased information, which reinforces the notion that information is persuasive if the source is credible (Walster, Aronson, & Abrahams, 1966). Since credible sources of information increase users' confidence, it is assumed that confidence in financial reporting will translate into users' reliance on the audited financial statements to make well-informed investing decisions. Auditors are seen as a group independent of management, have an objective view and can report on a company's activities without bias or conflict of interest. Our study proposes the following hypotheses to test this concept:

H1a: *The addition of an explicit clarification of auditor independence statement in an audit report, compared to no explicit clarification of auditor independence, will make the report more credible and enhance equity analysts' perceptions of auditor independence.*

H1b: *The addition of an explicit clarification of auditor independence statement in an audit report, compared to no explicit clarification of auditor independence, make the reports more credible and enhance equity analysts' perceptions of financial reporting reliability.*

H1c: *The addition of explicit clarification of auditor independence statement in an audit report, compared to no explicit clarification of auditor independence, will have a more positive effect on equity analysts' stock recommendations.*

The Moderation Effects of Internal Control Report and Research Questions

This study seeks to address whether the addition of an explicit clarification of auditor independence statement in the auditor report will make any difference to analysts' judgments and confidence in financial reporting, regardless of the type of internal control report that accompanies a standard audit report. The SEC rules (PCAOB, 2007) require firms to maintain procedures to evaluate and make specific disclosures regarding internal controls over financial reporting. Additionally, firms must include a report

from their auditors regarding management's assertions about the effectiveness of internal controls over financial reporting (SOX sections 302, 404, & 906; PCAOB, 2007). Thus, internal controls are designed to provide reasonable assurance regarding the achievement of a firm's objectives (AU section 319) with the reliability of financial reporting as one of the categories concerning the objectives (PCAOB, 2004). Ge & McVay (2005) conclude that effective internal control over financial reporting provides assurance that transactions are recorded in accordance with generally accepted accounting principles (GAAP) which ensures that fraud or material weaknesses are prevented or detected in a timely manner.

The accounting literature is replete with studies that have investigated the effect of internal control reports on users' decision-making and confidence in financial statements (Asare & Wright, 2012a; Ashbaugh-Skaife, Collins, Kinney, & LaFond, 2009; Beneish, Billings, & Hodder, 2008; Hammersley, et. al., (2008), Lopez, et. al., (2009), Schneider, et. al., (2009). Asare & Wright (2012a), for instance, posit that confidence in the standard audit report is higher when it is accompanied by an unqualified internal control report compared to an adverse report, suggesting that there is a direct relationship between the type of material weakness (entity-level weakness as against account-specific weakness) noted in an internal control audit report and users' confidence in the accompanying standard audit report. They suggest further that users' confidence in a contradictory report (adverse internal control report accompanying a standard unmodified audit report) will not be undermined if users are made aware that material internal control weaknesses are expected to translate into more substantive testing.

Furthermore, the literature suggests that the standard audit report on financial statements loses some credibility when it is combined with an adverse internal control report (Leech, 2004; Investors Service, 2004; Credit Suisse First Boston, 2005; Asare & Wright, 2012a). Dhaliwal, Hogan, Trezevant, & Wilkins (2011) posit that internal control material weakness increases a firm's credit spread and cost of debt. Thus, apart from Schneider, Gramling, Hermanson, & Ye (2009), who discount the effects of adverse internal control report on investing decisions, most other researchers suggest that an adverse internal control report has significant negative impact on investors' and users' judgments. Analysts use the information in the internal control report to assess the potential for material misstatements in the financial statements (information risk) as well as the auditor's ability to audit around the material weaknesses to identify the misstatements (Asare & Wright, 2012a). For instance, if there is an adverse internal control report, all other things being equal, users will expect a similarly qualified financial statement report, unless there is a compelling reason to believe that the auditor's substantiation (through rigorous substantive tests) has eliminated the information risk presented by the adverse internal control report.

Auditor independence enhances the reliability of management's financial reporting, because independent auditors will more likely issue adverse internal control opinions over financial reporting and point out any discovered internal control weaknesses (Zhang, et. al., 2007). An adverse internal control report may signal auditor toughness and could actually enhance confidence in audit reports, but message consistency is relatively higher when both reports are unqualified. The question then is how external parties' confidence in a clarified audit report differentiates under an adverse versus an unqualified internal control report. It is possible that the adverse internal control report would entice users to conclude that auditors did more substantive testing commensurate with material weaknesses. To test the logic behind this line of thinking, the study advances the following hypotheses:

***H2a**: An adverse internal control report, compared to an unqualified internal control report, will have a more positive effect on equity analysts' perception of auditor independence.*

***H2b**: An adverse internal control report, compared to an unqualified internal control report, with have a more negative effect on equity analysts' perception of financial reporting reliability.*

***H2c**: An adverse internal control report, compared to an unqualified internal control report, will have a more negative effect on analysts' stock recommendations.*

Lastly, it is not clear whether type of internal control report will make any difference in users' judgments and perceptions of auditor independence when clarification of auditor independence statement is added to the auditor's report. Thus, this study seeks to investigate that relationship (interaction effect), if any, with the following research questions:

***RQ1**: Will the effect of clarification of auditor independence vs. no clarification, on equity analysts' perceptions of auditor independence, be different when the type of internal control report is unqualified vs. qualified?*

***RQ2**: Will the effect of clarification of auditor independence vs. no clarification, on equity analysts' perceptions of financial reporting reliability, be different when the type of internal control report is unqualified vs. qualified?*

***RQ3**: Will the effect of clarification of auditor independence vs. no clarification, on equity analysts' stock recommendations, be different when the type of internal control report is unqualified vs. qualified?*

METHODOLOGY

Research Design and Independent Variables

This study employs a 2 x 2 between subjects experimental design. The two independent variables (an explicit clarification of auditor independence, and type of internal control report) are manipulated across two levels each. Type of internal control report (*adverse versus unqualified*) is an adaptation of the model used in Asare & Wright (2012a), Lopez. et. al., (2009), and Schneider & Church (2008). Auditor independence clarification is manipulated at two levels; *explicit clarification* versus *no explicit clarification*. The financial statement audit report is unqualified throughout the four scenarios. The four experimental groups for the study are shown below:

***Case 1**: An unqualified internal control report: without explicit clarification of auditor independence statement.*

***Case 2**: An unqualified internal control report: with explicit clarification of auditor independence statement.*

***Case 3**: An adverse internal control report, without explicit clarification of auditor independence statement.*

***Case 4**: An adverse internal control report, with explicit clarification of auditor independence statement.*

Participants

We used Qualtrics, a web-based survey services provider, to recruit equity analysts, one of the investor groups designated as "professional investors" by Bedard, Sutton, Arnold, & Phillips (2012). Similar to Brown-Liburd & Zamora (2015), the participants of our research are randomly selected from Qualtrics' panel data of 1, 476 professional equity analysts. The final usable sample consists of 123 complete respondents who satisfied the screening question which sets forth a minimum of one-year experience as a financial analyst, quota criteria to satisfy the 2×2 design, and speeding criteria (spending less than 3 minutes). Each of the 123 participants is randomly assigned to one of four groups and provided with an experimental case describing one of four scenarios. All participants receive a summary performance measures report, and additional summarized information, similar to the model used in Christensen, Glover, & Wolfe (2014).

Similar to prior studies that employ professional investors such as venture capitalists, fund managers, and financial analysts as subjects, our study uses equity analysts, who are sophisticated professional and

public financial statement users because they are among the investor groups who constantly analyze audited financial statements (McEnroe & Martens ,2001). Therefore, it is our expectation that the findings of the study may be generalized to other sophisticated user groups.

Demographic data on the 123 participants in the study include participants' (1) gender; (2) work experience; (3) use of internal control audit reports; (4) understanding of the auditor's opinion; (5) understanding of internal control report; (6) use of financial reports; (7) job title; and (8) level of formal education. Participants are fairly evenly distributed among the four groups, ranging from 26 to 33 participants per condition or treatment. As for the 123 equity analysts in the sample for analysis, around 31 percent of participants are female, while 69 percent are male; 88 percent of participants reported that they have over five years' experience as equity analysts. Also, 80 percent use internal control reports on average or frequent basis, 92 percent have average or full knowledge of the auditor's opinion, 88 percent report that they have average or full understanding of internal control audit report, 91 percent use financial reports on average or frequent basis. Also, around 74 percent of participants use the designation Equity Analyst or Fund Manager. Ten of the 32 'other' respondents (about 9 %) are financial analysts, and the remaining 22 participants have various titles like Accounting Analysts, Equity Derivatives V.P., Risk Analysts. Lastly, 94 percent of respondents have either a bachelor's or master's degree. From the above statistics, it can be safely concluded that the participants are experienced and well qualified analysts (whose major job function is to analyze financial reports for investment purposes) suitable for this study, thus lending credence to the validity of the study. All participants who passed the screening and manipulation tests self-reported that they had analyzed corporate securities for investment purposes and stock recommendations in the last two years.

Experimental Task

This study uses a three-part instrument which includes an experiment (Part 1), manipulation check (Part 2), and demographic information (Part 3) to examine analysts' confidence assessments, and judgments (stock recommendations).

Background information about Shoprite Superstore (its public status, the size of the company, its products) is provided in each of the four-case scenarios. After analyzing the auditor's report and summary performance measures, participants are asked to assume they are evaluating the investment worthiness of Shoprite Superstore by indicating their (1) confidence in the audit reports, and (2) the likelihood of relying on the report when making stock recommendations.

Lastly, consistent with Schneider & Church (2008), participants are asked to provide demographic information which includes gender, work experience, use of audited reports, participants' understanding of the auditor's opinion, understanding of internal control report, how often participants use financial reports, and highest educational level attained.

Information about Shoprite Superstore, a hypothetical company, and summary performance measures are the same for all four groups of participants, but the reports of the Independent Registered Public Accounting Firm are different. Subjects in all four cases are informed that the auditors issued combined reports on the financial statements and internal controls. This system of reporting on both financial statements and internal controls follows the implementation of SOX and PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit Of Financial Statements* (PCAOB, AS2, and Auditing Standard 5 (PCAOB, AS 5)*, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statement*s.

Dependent Variables

Equity analysts' confidence in financial reporting, is measured in terms of the perceptions of auditor independence, and perceptions of financial reporting reliability, adopted from Jennings, Pany, & Rockers (2006). Analysts' decision-making process is measured with questions related to the likelihood of making stock recommendations to clients, similar to the designs used in Lopez et. al. (2009) and Asare & Wright (2012a). The effects of auditor independence clarification and type of internal control report on analysts' perceptions of auditor independence and financial reporting reliability are measured using a 7-point

Likert-type scale anchored at 1 = Low confidence, to 7 = High confidence. Also, the likelihood of making stock recommendations is measured on a scale anchored at 0% = No Chance, to 100% = Certain to Invest.

Manipulation Checks

Manipulation checks are designed to evaluate participants' understanding of the experimental task, and exclude participants who lack inclusion importance (Yates, 1990). Participants are asked to answer two questions based on clarification of auditor independence and internal control audit report, without going back to read the report. Participants who do not answer the questions correctly are assumed not to comprehend the test, so that their responses are not included in the statistical analysis and the findings of the experiment. All 123 subjects of the study passed the manipulation check questions.

RESULTS

Two-way between-groups ANOVA and simple effects tests are used to analyze and report the main effects of the two categorical independent variables, *explicit clarification of auditor independence* (Explicit Clarification vs. Non-Explicit Clarification) and *type of internal control report* (Unqualified vs. Adverse) on equity analysts' confidence in financial reporting and investing judgments. The results of the experiment are presented in the following subsections: 1) Perceptions of Auditor Independence, 2) Perceptions of Financial Reporting Reliability, and 3) Likelihood of Making Stock Recommendations.

Perceptions of Auditor Independence

H1a examines the main effect of the two independent variables—explicit clarification of auditor independence vs. no clarification, and type of internal control report (unqualified vs. qualified) on the first dependent variable: perceptions of auditor independence. According to Table 1, H1a is supported: the addition of an explicit clarification of auditor independence has a positive effect on perceptions of auditor independence (Panel A: $F_{1,122} = 3.904$, $p = .050$, and Panel B: Clarification, Mean = 5.48, SD = 1.18; No clarification, Mean = 5.03, SD = 1.26). The results show that an explicit clarification of auditor independence statement (compared to no clarification of auditor independence) significantly affect perceptions of auditor independence. This implies that the addition of an explicit clarification of auditor independence statement in the auditor's report significantly, positively impact financial report users' perceptions of the auditor's independence. This finding echoes the position of the PCAOB which states that a statement that explicitly clarifies the auditor's independence in the audit report would assure financial report users that auditors understand they have a responsibility to be independent of the company and have complied with applicable independence requirements of the PCAOB and the Securities and Exchange Commission.

H2a predicts that an adverse internal control report, compared to an unqualified report, will have a positive effect on the perceptions of auditor independence. The results shown in Table 1, Panels A and B do not support H2a. Contrary to the prediction an adverse internal control audit report, compared to an unqualified internal control report, does not have a statistically positive significant effect on the perceptions of auditor independence (Panel A: $F_{1,122} = .006$, $p = .939$, one-tailed; Panel B: Adverse report, Mean=5.29; SD = 1.20; Unqualified report, Mean=5.25; SD =1.27).

One practical implication of this finding is that type of internal control report does not influence equity analysts' perceptions of auditor independence. Analysts' do not perceive an adverse internal control report and an unqualified internal control report differently in statistically terms, even though their mean scores are above the scale's midpoint of 4. The study fails to find evidence to support the suggestion by Zhang et. al., (2007) that auditors who issue adverse internal control reports are independent, compared to those who issue unqualified reports. Regardless of type of internal control report (unqualified report or adverse report), analysts rate their perceptions of auditor independence at the higher end of the 7-point scale.

RQ1 examines the interaction effect between clarification of auditor independence and type of internal control report and finds no significant interaction ($F_{1,122} = 1.445$; $p = .232$). This is shown in

Table 1, Panel A. One practical implication of this finding is that type of internal control report does not influence equity analysts' perceptions of auditor independence.

In summary, the findings suggest that an explicit clarification of auditor independence provides relevant information about the auditor's independence to users of financial reports as is intended in the PCAOB new standard on the auditor's report (AS, 3101). A clarification statement in the audit report will remind) auditors of their obligations to be independent of their clients, but an adverse internal control report is not perceived differently from an unqualified report by analysts regarding independence. Also, the interaction effect between explicit clarification of auditor independence and type of internal control report is not statistically significant.

TABLE 1
EFFECTS OF CLARIFICATION OF AUDITOR INDEPENDENCE ON PERCEPTIONS OF AUDITOR INDEPENDENCE[1]

Panel A: Analysis of Variance for Perceptions of Auditor Independence

Source	Hypotheses	Sum of Squares	df	Mean Square	F	Sig[2]
Test Variables						
Clarification	H1a	5.832	1	5.832	3.904	.050
I/C Report	H2a	0.009	1	0.009	0.006	.939
I/C Report*Clarification	RQ1	2.159	1	2.159	1.445	.232
Error		177.757	119	1.494		
R^2 = .045						

Panel B: Descriptive Statistics (Mean, Standard Deviation and N)

		No Clarification	Clarification	Total
IC-Unqualified	Mean	4.91	5.61	5.25
	SD	1.33	1.12	1.27
	N	33	31	64
IC-Adverse	Mean	5.19	5.36	5.29
	SD	1.17	1.25	1.20
	N	26	33	59
Total	Mean	5.03	5.48	5.27
	SD	1.26	1.18	1.24
	N	59	64	123

[1] Perception of auditor independence is measured on a 7-point scale, with end-points Labeled 1 = Low Confidence, and 7 = High Confidence.
[2] Sig. stands for significance (.05), one-tailed.

Perceptions of Financial Reporting Reliability

Results of the financial reporting reliability assessments are summarized in Table 2, Panels A and B. H1b predicts that the addition of an explicit clarification of auditor independence statement in the audit report will have a more positive effect on equity analysts' perceptions of financial reporting reliability. This prediction is supported by the findings. The two-way analysis of variance reports shows that the inclusion of explicit clarification of auditor independence statement on the body of the audit report has a statistically significant effect on equity analysts' perceptions of financial reporting reliability ($F_{1,122}$ = 7.900; p = .006; Clarification of auditor independence; Mean = 5.20, SD = 1.48; No clarification of auditor independence: Mean = 4.51, SD = 1.50). The findings imply that clarification of auditor independence on the body of the audit report (not only in the title) reinforces the independence obligations required of auditors, which translates into producing reliable financial reports needed by equity analysts, investors and other financial report users to make better and well-informed investing judgments. As the PCAOB regulators expect, equity analysts seem to believe that the auditor independence requirement will enhance financial report users' understanding of the auditor's existing obligations to be independent and serve as a reminder to auditors.

As predicted in H2b, an adverse internal control report, compared to an unqualified internal control report has a statistically significant negative effect on equity analysts' perceptions of financial reporting reliability (Table 2, Panel A, $F_{1,122}$ = 4.531, p = .035, one-tailed). The results imply that analysts' confidence in financial reports is higher when the internal control report is unqualified. The finding supports H2b and provides evidence that financial reporting reliability is impacted by the type of internal control report. Thus, the prediction that an adverse internal control report will have a negative effect on equity analysts' perceptions of financial reporting reliability (Table 2, Panel B: Adverse Report, Mean = 4.61, SD = 1.65; compared to Unqualified Report, Mean = 5.11, SD = 1.37) is supported. The statistically significant difference between the two groups signifies that users' perceptions of the reliability of financial reports are lower in the presence of an adverse internal control report. In practical terms, an adverse internal control report undermines perceptions of financial reporting reliability and thus reduces equity analysts' and other users' reliance on the reports for investment decisions.

The interaction effect (RQ2) between type of internal control report and explicit clarification of auditor independence on analysts' perceptions of financial reporting reliability is not significant in statistical terms ($F_{1,122}$ = 1.050, p = .308). This implies that the effect of either independent variable on perception of financial reporting reliability is mutually exclusive. Please, see Table 2, shown on next page for results of this section of the study.

TABLE 2
EFFECTS OF CLARIFICATION OF AUDITOR INDEPENDENCE ON PERCEPTIONS OF FINANCIAL REPORTING RELIABILITY[1]

Panel A: Analysis of Variance for Perceptions of financial reporting reliability

Source	Hypotheses	Sum of Squares	df	Mean Square	F	Sig[2]
Test Variables						
Clarification	H1b	17.092	1	17.092	7.900	.006
I/C Report	H2b	9.802	1	9.802	4.531	.035
I/C	RQ2	2.271	1	2.271	1.050	.308
Report*Clarification		257.452	119	2.163		
Error						
R^2 = .093						

Panel B: Descriptive Statistics (Mean, Standard Deviation and N)

		No Clarification	Clarification	Total
IC-Unqualified	Mean	4.88	5.35	5.11
	SD	1.39	1.33	1.37
	N	33	31	64
IC-Adverse	Mean	4.04	5.06	4.61
	SD	1.54	1.62	1.65
	N	26	33	59
Total	Mean	4.51	5.20	4.87
	SD	1.50	1.48	1.53
	N	59	64	123

[1] Perception of Financial Reporting Reliability is measured on a 7-point scale, with end-points labeled 1 = Low Confidence, and 7 = High Confidence.
[2] Sig. stands for significance (.05), one-tailed.

Likelihood of Making Stock Recommendations

Table 3, Panels A, B, and C presents the results regarding equity analysts' likelihood of making stock recommendations (H1c, H2c, and RQ3). Panel A presents the results of ANOVA on the likelihood of making stock recommendations to clients. Panel B presents the simple effects tests conducted to explore the differences among the cell means following the significant interaction. Panel C presents the descriptive statistics.

TABLE 3
EFFECTS OF CLARIFICATION OF AUDITOR INDEPENDENCE ON THE LIKELIHOOD OF MAKING STOCK RECOMMENDATIONS TO CLIENTS[1]

Panel A: Analysis of Variance for Likelihood of Making Stock Recommendations

Source	Hypotheses	Sum of Squares	df	Mean Square	F	Sig[2]
Test Variables						
Clarification	H1c	15489.070	1	15489.070	31.468	.000
I/C Report	H2c	5272.294	1	5272.294	10.711	.001
I/C Report*Clarification	RQ3	1942.323	1	1942.323	3.946	.049
Error		58573.231	119	492.212		
R^2 = .262						

Panel B: Analysis of Simple Effects

IC Report Type	Clarification	Mean Square	F	Sig.
Unqualified Report	No Clarification v. Clarification	3390.92	6.89	.010
Adverse Report	No Clarification v. Clarification	13560.11	27.55	.000

Panel B: Analysis of Simple Effects (continued)

Clarification	IC Report Type	Mean Square	F	Sig.
No Clarification	Unqualified v. Adverse	6500.33	13.21	.000
Clarification	Unqualified v. Adverse	427.42	.87	.353

Panel C: Descriptive Statistics (Mean, Standard Deviation and N)

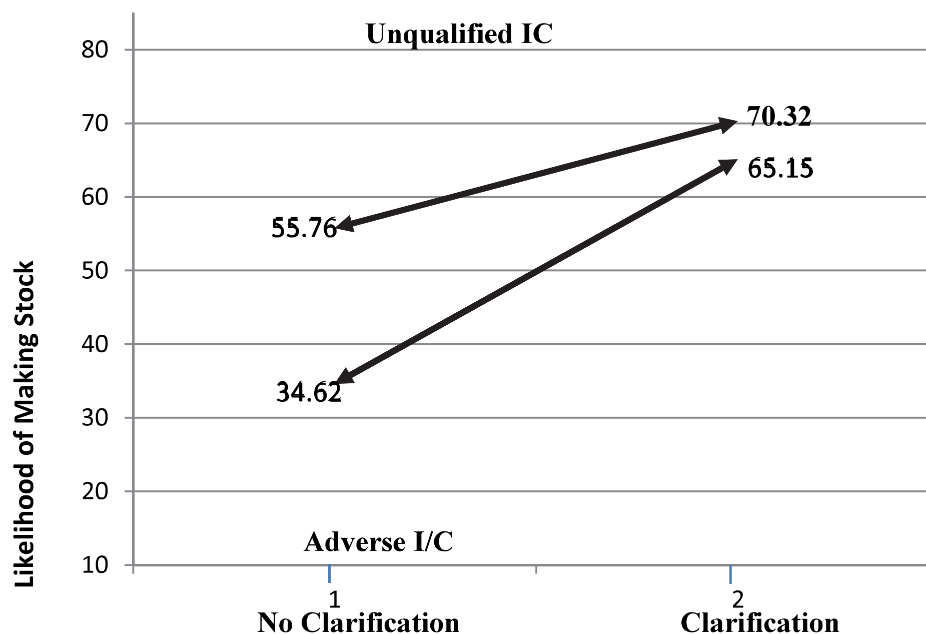
		No Clarification	Clarification	Total
IC-Unqualified	Mean	55.76%	70.32%	62.81%
	SD	21.36	16.83	20.51
	N	33	31	64
IC-Adverse	Mean	34.62%	65.15%	51.69%
	SD	23.19	26.24	29.08
	N	26	33	59
Total	Mean	46.44%	67.66%	57.48%
	SD	24.41	22.16	25.50
	N	59	64	123

[1] Likelihood of making investing recommendations is measured on a 100-point scale, labeled 0 = No Chance, and 100% = Certain to Invest.
[2] Sig. stands for significance (.05), one-tailed.

According to Panel A of Table 3, H1c is supported: the addition of an explicit clarification of auditor independence statement (Clarification; M = 67.66%, SD = 22.16; No clarification, M = 46.44%, SD = 24.41) results in a significant main effect ($F_{1,122} = 31.47$, $p < .001$). An auditor independence clarification enhances equity analysts' confidence in financial reporting, and facilitates their investing judgments when they make stock recommendations. Analysts seem to believe that the clarification of auditor independence statement in the audit report by auditors themselves is persuasive because it comes from credible sources outside the company's management. Prior studies have shown that credible sources

increase users' confidence in financial reports because such sources are reputed to have both the ability and motivation to provide unbiased, sufficient and relevant information for investors, analysts and other users. As shown in Panel A, Table 3, the main effect of type of internal control report ($F_{1,122}$ = 10.71, p = .001, one-tailed), is statistically significant. H2c is supported: an adverse internal control report has a significant negative main effect (Panel C, Mean = 51.69%, SD = 29.08), compared to an unqualified report (Panel C, Mean = 62.81%, SD = 20.51). The significant negative effect of an adverse internal control report implies that internal control reports are valuable and relevant source of information for users when making stock recommendations. Since confidence in financial reports affect investment judgments (Asare & Wright, 2012a), an adverse internal control report erodes confidence in financial reporting, which results in less reliance on financial reports for investment purposes, even if it is integrated in a standard audit report. The reality is that financial statements lose credibility when there is no consistency between the reports.

FIGURE 1
CELL MEANS FOR LIKELIHOOD OF MAKING STOCK RECOMMENDATIONS



RQ3 which explores the relationship between an explicit clarification of auditor independence and type of internal control audit report is statistically significant ($F_{1,122}$=3.94; p = .049). Given the significant interaction between the two independent variables (Figure 1), we conduct simple effects tests (planned contrast) as follow-up tests to explore further the nature of the interaction. The resulting simple effects (Panel B) show that both clarification of auditor independence and type of internal control report have a statistically significant effect on analysts' stock recommendations. This means that regardless of type of internal control report, clarification of auditor independence statement in the auditor's report assures users that auditors understand their independence obligations, and have complied with all independence requirements outlined by the PCAOB and the SEC, thus encouraging reliance on the reports for stock recommendations.

DISCUSSION AND CONCLUSIONS

The primary objective of this study is to provide empirical evidence on whether the inclusion of an explicit clarification of auditor independence statement would impact users' perceptions about the

auditor's independence (H1a). Our research suggests that adding an explicit clarification of independence statement in the auditor's report (in addition to the title of the report which reads "*Report of Independent Registered Public Accounting Firm*'') would be persuasive enough to enhance the confidence of users of financial reports that auditors understand their obligations to be independent as the PCAOB posit. Confidence in financial reporting will translate into reliance on audited financial reports when making investing judgments (stock recommendations).

A secondary objective of the study is to investigate whether the type of internal control report (unqualified report vs. adverse report) moderates the effects of an explicit clarification of auditor independence on users' confidence in financial reports and subsequently, on analysts' stock recommendations. Our findings suggest that type of internal control report does not influence equity analysts' perceptions of auditor independence (H2a). However, as predicted in H2b, an adverse internal control report, compared to an unqualified internal control report, has a statistically significant negative impact on equity analysts' perceptions of financial reporting reliability. The results imply that analysts' confidence in financial reports is higher when the accompanying internal control report is unqualified, regardless of whether there is clarification statement or no clarification statement. Table 4 presents a summary of the findings of our research.

TABLE 4
SUMMARY OF EXPERIMENTAL FINDINGS

		Independent Variables		
	Dependent Variables	**Clarification of Auditor Independence**	**Type of Internal Control Report**	**Interaction Effect**
1	Perceptions of Auditor Independence.	Significant p = .050 (H1a)	Not Significant p = .939 (H2a)	Not Sig. p = .232 (RQ1)
2	Perceptions of Financial Reporting Reliability.	Significant p = .006 (H1b))	Significant p = .035 (H2b)	Not Sig. p = .308 (RQ2)
3	Likelihood of Stock Recommendation	Significant P < .001 (H1c)	Significant P < .001 (H2c)	Significant P = .049 (RQ3)

This study contributes to accounting research and practice by providing insights into the gap in the literature as a result of the new clarification concept. Equity analysts perceive that expanding the auditor's reporting format to include an explicit clarification of auditor independence statement is informative and assuring because auditors will be constantly reminded of their obligations to be independent. This finding supports the expectations of the AS 3101, (PCAOB, 2017).

The concept of clarification of auditor independence in the auditor's report has not been tested, so it stands to reason that any empirical evidence supporting or discrediting it will be of immense help to regulators, researchers and practitioners of accounting as a whole, and auditors in particular. The study lends credence to Manson & Zaman's (2003) contention that any additional relevant financial disclosures are beneficial in improving users' judgments and market outcomes.

This study, like most experimental studies, has limitations which should be considered when one interprets the results. First, the information about the hypothetical company used in the experiment was abridged to fit the screen and encourage maximum participation. This approach excludes detail information that could help participants in their responses and thus reduce the fairly high manipulation

failure rate. Future studies on explicit clarification of auditor independence should explore the possibility of making more relevant data available to participants.

Secondly, while equity analysts are important stakeholders whose understanding and use of financial reports deserve study, the findings may not be generalized to other stakeholders such as bank loan officers, attorneys, jurors and non-professional investors who may have motives that predispose them to interpret the data provided in the experiment differently. For instance, lenders usually have access to more information about the company prior to making lending decisions. Future research may investigate how other professionals use an explicit clarification of the auditor's independence in the audit report to make judgments about auditor independence, the reliability of financial reports and their impact on stock recommendations.

Thirdly, our study utilizes perceptions of auditor independence and perceptions of financial reporting reliability to measure confidence in financial reporting. Future research could explore other ways of measuring confidence in financial reporting, for example, perceptions of audit quality.

Finally, the data collection method used in the study is relatively new. Participants in the experiment were given a link to a web-based case study hosted by *Qualtrics*. While this could affect the reliability of the data, the authors take solace in the fact that some recent studies, including Christensen, et. al., (2014), Abbot, Brown, & Higgs (2016) used same approach and the reports from this new data collection method seem to be holding. Christensen, et. al., (2014) was published in *Auditing: A Journal of Practice and Theory*, while Abbot, et. al., (2016) was published in *Behavioral Research in Accounting.* This is a vindication of Qualtrics' online data collection method because the papers were published in reputable accounting journals.

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