The unintended consequences of uncertainty disclosures made by auditors and managers on nonprofessional investor judgments

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ABSTRACT

We examine how recent proposals requiring augmented auditor and management disclosures highlighting estimate uncertainty influence investors’ judgments and decisions. Specifically, we investigate the effects of auditor emphasis of matter (EOM) paragraphs, both independently and in combination with management disclosures of estimate ranges, on investors’ likelihoods to invest. Using an experiment with nonprofessional investor participants, we find that the EOM has the unintended consequence of increasing investors’ perceptions of management credibility, leading to higher likelihood of investment. Furthermore, despite the ability of ranges to highlight uncertainty and downside risk, we find that management’s disclosure of an estimate range does not impact the positive effect of the EOM on investors’ propensities to invest, unless management provides a wide range. In this circumstance, we find that a wide range mitigates the positive influence of the EOM on investment decisions. Our results have important implications for regulators, preparers, and users of financial statements as we find that augmented auditor and management reporting may have unintended consequences on investor perceptions of management credibility and resultant investment decisions.

1. Introduction

A decade of egregious corporate malfeasance, punctuated by the credit crisis of 2007–2008, has highlighted serious concerns in current financial reporting and auditing practices. The public’s diminished trust – and resultant demands for transparency – in financial reporting has led standard setters to revisit auditors’ and managers’ roles in financial reporting. Despite changes in financial reporting resulting from the Sarbanes-Oxley Act of 2002, concerns still exist that investors do not appropriately identify and account for the uncertainty inherent in financial statement estimates when making investment decisions (SEC, 2011; 2006). In light of these concerns, regulators (e.g., FASB, 2014) and academics (e.g., Bell & Griffin, 2012; Bratten, Gaynor, McDaniel, Montague, & Sierra, 2013) have made calls for research investigating ways to enhance the salience of uncertainty inherent in financial reporting.

To address these issues, regulators recommend two changes to current financial reporting practices. First, on the audit side, the Public Company Accounting Oversight Board (PCAOB) and its international counterpart, the International Auditing and Assurance Standards Board (IAASB), suggest that augmented auditor reporting such as emphasis of matter paragraphs in the auditor’s report (hereafter, “EOM”) will draw attention to and thereby increase the salience of management’s uncertainty disclosures (PCAOB, 2016; 2013; IAASB, 2013). Second, on the entity side, the Financial Accounting Standards Board (FASB) submits that providing investors a range of possible outcomes for estimates will highlight the uncertainty inherent in determining financial statement estimates (FASB, 2014). We propose, however, that these effects are not as straightforward as regulators suggest, particularly when they are implemented jointly. Thus, we examine the effects of auditor EOMs, both independently and in combination with management disclosures of estimate ranges, on investor judgments and decisions.

Prior research demonstrates that, consistent with regulators’ expectations, EOMs are effective mechanisms for directing investors'
attentions to specific disclosures (Sirois, Bédard, & Bera, 2017) and that they provide information to investors about financial statement quality (Czerny, Schmidt, & Thompson, 2014). Thus, one might logically expect that if an EOM directs investors’ attentions to an entity-provided footnote highlighting estimate uncertainty, given investors’ aversions to losses (Tversky & Kahneman, 1991), this would decrease investors’ propensities to invest. However, there is evidence to suggest that investors may not respond to EOMs in this manner.

Psychology research shows that when processing information from a variety of sources, individuals’ judgments are guided by credibility cues wherein they place greater importance upon information from sources deemed more credible and will often discount information from other sources (Chaiken & Maheswaran, 1994). This credibility heuristic has been observed in the context of auditor reporting such that investors look to the audit opinion as a cue about the credibility of management and its disclosures (Mercer, 2004). Building upon this research, we develop two complementary theoretical arguments to support our expectation that expanded auditor reporting (via an EOM) will produce stronger credibility effects, and more positive investment decisions, than standard auditor reporting (i.e., no EOM).

First, we draw from psychology research showing that repeated exposure to a message enhances the credibility of the message (Chen & Tan, 2013; Hasher, Goldstein, & Toppino, 1977; Koch & Zerback, 2013). Specifically, this literature suggests that as individuals are exposed to a message for a second time, the message becomes more familiar and is perceived as more credible. Given that an EOM draws attention to management’s disclosure by both describing the disclosure and referencing where the disclosure can be found in the financial statements, we expect that this repeated exposure engendered by the EOM will enhance investors’ perceptions of management credibility. Second, we rely on prior psychology research showing that message length positively impacts judgments. Specifically, we argue that credibility effects will be strengthened when information from the auditor is expanded, as longer messages have a greater impact on judgments than shorter messages (i.e., “length implies strength”; e.g., Wood, Kallgren, & Preissler, 1985). In light of the credibility-enhancing effects of repeated exposure and expanded auditor reporting, we posit that an EOM will increase investors’ perceptions of management credibility, thereby increasing their likelihoods to invest.

We also consider the extent to which EOM effects vary in the presence of management’s range disclosure. Ranges highlight uncertainty by suggesting multiple possible outcomes (Du, Budescu, Shelley, & Omer, 2011) and lead to a more uncertain information environment (Tang, Zarrowin, & Zhang, 2015). Because ranges enhance the salience of uncertainty and downside risk (Du et al., 2011; Tang et al., 2015), one might expect that an EOM highlighting these characteristics will decrease investors’ propensities to invest. However, prior research demonstrates that the use of cues as a heuristic is especially evident in situations of uncertainty (Fischhoff, Slovic, & Lichtenstein, 1977). Thus, we suggest that increasing the salience of uncertainty via a range will affirm investors’ tendencies to rely on the EOM as a cue about management’s credibility, thereby undermining the expected range effects and increasing investors’ propensities to invest. That is, we predict that management’s disclosure will not influence the effect of the EOM on investors’ propensities to invest.

To address these issues, we conduct a 2 × 2 between-participants experiment in which nonprofessional investors read a patent infringement case and related disclosures from management and the auditor. Management’s disclosure is a footnote accompanying the financial statements that discloses the recorded estimate for a patent infringement loss and either includes or does not include a range of possible outcomes related to the loss. The auditor’s disclosure is an unqualified or “clean” audit report that either provides or does not provide an EOM specifically referencing management’s disclosure. Investors then make an investment decision and answer a series of questions regarding management’s and the auditor’s disclosures.

Consistent with our expectations, we find that an EOM paragraph increases investors’ likelihoods to invest in a company. Further, management’s provision of a range in its uncertainty disclosure has no impact on the positive effect of the EOM on investment decisions. Mediation analyses show that the effects of the EOM on investment decisions are driven by investors’ perceptions of management credibility. Overall, we find that while the EOM has the intended effect of highlighting management’s uncertainty disclosure, it also has the unintended consequence of increasing investors’ perceptions of management credibility, and resultant investment decisions, even when management highlights uncertainty via a range. In additional investigation, we explore the effect of the EOM when management provides a wide range that presents more uncertainty (i.e., more downside risk) to the investor. Results reveal that enhancing the salience of uncertainty via a wide range mitigates the positive effect of the EOM on investment decisions. These results demonstrate potential tradeoffs that may occur when implementing joint disclosures from auditors and management.

Our results have important implications for both research and practice. Our findings extend a growing body of research exploring the impact of proposed regulatory standards on practice (e.g., Gagnier, McDaniel, & Yohn, 2011; Lachmann, Sefani, & Wöhrmann, 2015) by examining how proposals for expanded auditor and management reporting influence investors’ judgments and decisions. Specifically, our study adds to the auditor disclosure literature by showing that EOMs not only influence investors’ attentions to highlighted disclosures (Sirois et al., 2017), but they also influence their ultimate investment decisions via perceptions about management credibility. Thus, although we find support for standard setters’ claims that the EOM may increase the salience and informativeness of management’s uncertainty disclosures, we also detect an unintended positive effect of the EOM on investment decisions. Further, we find that management’s provision of a range in its disclosure does not impact the positive effect of the EOM on investment decisions, unless the range is wide. We therefore also contribute to extant literature by shedding light on the efficacy of using ranges in financial reporting. In summary, our findings reveal unintended consequences of implementing joint disclosures from dual sources (i.e., auditors and management), and should therefore be of critical importance to regulators and the parties crafting, reviewing, and utilizing these disclosures.

The remainder of the paper is organized as follows. The next section discusses the previous literature and develops the hypotheses. The third section describes the research method, and the fourth section discusses the results. The final section summarizes the overall findings, implications, and directions for future research.

2. Background and hypotheses development

2.1. Auditor’s emphasis of matter (EOM)

The auditor’s report is the primary vehicle used to communicate the findings of financial statement audits (PCAOB, 2011). There has been a long-standing debate over whether the current form and content of the auditor’s report is sufficient to meet investors’ needs and whether expanding the audit report will enhance the communicative value of the audit report. Investors argue that the current reporting model inadequately reflects the growing complexity in business, financial reporting, and auditing and that it would be worthwhile to include information about the audit process and the quality of financial statements, including uncertainties surrounding critical accounting
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