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THE AUDITOR'S REPORT ON INTERNAL CONTROL & FRAUD DETECTION RESPONSIBILITY: A COMPARISON OF FRENCH AND U.S. USERS' PERCEPTIONS

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Abstract

The AICPA recently finished a harmonization project to converge U.S. audit standards with those of the International Audit and Assurance Standards Board. The assumption implicit in this project is that users of financial statements will benefit from a converged, or consistent set of audit standards. Additionally, the AICPA's clarified auditing standard AU-C700, *Audit Conclusions and Reporting*, now requires explicit acknowledgement of the auditor's responsibility for fraud procedures in the auditor's report, which is the focus of advisory committees in both the U.S. Department of

Treasury and the European Commission. Therefore, the purpose of this study is to investigate how users (U.S. and French) rate a harmonized audit communication. Specifically, we test perceptions of the auditor's internal control report using the PCAOB's AS2 report. Results indicate that U.S. and French users rate the report similarly, with no significant differences along dimensions of *readability*, *reliability*, and *liability*. Additionally, we investigate how user perceptions change when evaluating a report that contains wording as to the auditor's fraud detection responsibility. Results indicate that while U.S. users' perceptions increase positively when fraud wording is added, French perceptions remain unchanged. Overall, our results suggest that both U.S. and non-U.S. users perceive the information from an auditor's internal control report the same. However, specific wording changes (like fraud) do not universally increase positive perceptions perhaps because of country-specific legal and regulatory environments.

INTRODUCTION

The harmonization of financial accounting and reporting standards has received much attention over the last few years (for example, Daske et al., 2008; Hail et al., 2010a, 2010b; Bradshaw et al., 2010). A much less public harmonization project, however, has recently been concluded by the American Institute of Certified Public Accountants (AICPA). This Clarity Project rewrote every Statement on Auditing Standards (SAS) to converge as far as possible with International Standards on Auditing (ISA). During the Clarity Project, the AICPA's Auditing Standards Board harmonized its agenda with the International Audit and Assurance Standards Board (IAASB) in an effort to converge U.S. GAAS

with international standards. This Clarity Project is an important step in the globalization of auditing standards. As such, the purpose of this research is to compare perceptions of harmonized audit communications across U.S. and non-U.S. users.

In particular, we use the auditor's internal control report as an example of a harmonized audit communication. Since the passage of the Sarbanes-Oxley Act in 2002, internal control reporting has been a much debated topic in the U.S. and Europe (Baker, 2005; Gornik-Tomaszewski & McCarthy, 2005; Baker, 2006). In particular, the European Commission (EC) has issued what is referred to as EuroSox, amendments to the Fourth, Seventh and Eight directives. Related to internal control reporting, these revised directives require company directors to describe their internal control processes in annual reports. While these requirements stop short of requiring an external audit opinion, they do require external auditors to ensure the reports are consistent with the company's financial statements and require that external auditors provide the audit committee with an annual report on internal control (Baker, 2005).

Additionally, the auditor's responsibility for fraud detection has received much global attention. During the timeframe of the Clarity Project the IAASB issued ISA 240 (redrafted), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* in 2006 and the AICPA issued SAS 113, C*onsideration of Fraud in a Financial Statement Audit*, in 2007. Both standards require auditors to design and perform audit procedures to detect and prevent material misstatements due to fraud (Selley & Turner, 2004) with an emphasis on procedures designed to understand internal controls related to financial reporting (Ramos, 2003).

Furthermore, the AICPA recently issued clarified statement AU-C 700, *Audit Conclusions and Reporting*, which prescribes a revised auditor's report to include: (i) management's responsibility to implement *"internal control relevant to the preparation and fair presentation of financial statements that are free from material*

misstatement, whether due to fraud or error" and (ii) auditor's responsibility for designing audit procedures depending on the *"auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error."*[1]

Therefore, the purpose of this study is two-fold. First, given the move toward the globalization of audit standards, the study investigates non-U.S. user's perceptions of the auditor's internal control report and compares those perceptions to a sample of U.S. users. Second, the study examines the impact of fraud wording on non-U.S. users' evaluation of the report. Previous research on U.S. users suggests that the inclusion of fraud detection wording enhances users' evaluation of the report when compared to the mandated report that does not contain such wording (Foster et al., 2010).

In this regard, we obtained and analyzed data using a between-subjects experiment with 92 U.S. and 72 French subjects as proxies for financial statement users. Subjects were MBA students from a university in the Midwest region of the United States and senior level accounting/finance students from a university in the north of France. Participants were asked to evaluate one of three auditor report formats on internal control effectiveness over financial reporting: the Public Company Accounting Oversight Board (PCAOB) AS2 mandated report with a *limitations* paragraph (labeled as AS), the AS report without the limitations paragraph (labeled as NL), and the NL report with fraud wording (labeled as FW).

Based on the results of similar prior work (e.g., Foster et al., 2005; Foster, et al., 2010) participants' responses to survey questions about the three auditor's report formats (AS, NL, & FW) were collapsed into three perceptual dimensions: *readability*, *reliability* and *auditor liability*. Results of analyses indicate that

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[1] AU-C 700, *Audit Conclusions and Reporting*, will become effective for audits of financial statements for the year ending on or after December 15, 2012.

perceptions of French and U.S. users' do not differ when evaluating the prescribed PCAOB report on internal controls (AS format). Perceptions do differ, however, when fraud wording is added to the report (FW format). In particular, U.S. users' perceptions about the FW format are significantly favorable/positive, while French users' perceptions remain unchanged.

Overall, we expand the growing literature on accounting harmonization by adding audit harmonization into the discussion. To date, we are aware of no study that investigates the potential impact of audit harmonization on users' perceptions of audit communications. Additionally, our study complements previous studies (Ashbaugh-Skaife et al., 2007; Beneish et al, 2008; Hammersley et al., 2008; Schneider and Church, 2008; Lopez et al., 2009) that suggest an auditor's internal control report provides information to users that is value relevant. By documenting that U.S. and French users' rate the PCAOB report similarly, our results suggest that an auditor's internal control report could provide value relevant information to users outside the U.S.

Moreover, the inferences drawn from the evidence in this study are useful to regulators, especially when confronted with the impact this audit harmonization project between the AICPA and IAASB may have on the PCAOB. Specifically, the Clarity Project is the first complete redrafting and recodification of U.S. audit standards since 1972 (Morris & Thomas, 2011). Since the PCAOB has remained silent on the issue of harmonized auditing standards, the impact of this globalization on U.S. public companies is unknown.

The PCAOB, however, does review its audit standards for revision based on its independent analyses of the continuing applicability of existing interim standards, PCAOB inspections, and economic developments (Morris & Thomas, 2011). Evidence that U.S. and French users rate the internal control report similarly provides support to the PCAOB their report format benefits a potentially diverse user group and may help to shape any

harmonization of their standards and globalization of audit reporting.

Furthermore, the differing U.S. and French perceptions regarding the inclusion of fraud wording in the internal control report would be useful to regulators as they raise concerns about the adequacy of audit reports. Specifically, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession recommended the PCAOB clarify in the audit report the auditor's role in detecting fraud.[2]

Additionally, the European Commission and the Audit Practices Board of the United Kingdom are currently discussing potential changes to their respective auditor reports (Grant, 2008) due to user misperceptions, among other things, regarding the auditor's responsibility for fraud (Gray et al., 2011). Evidence that fraud wording in an auditor's internal control report enhances U.S. users' perceptions and not French users' perceptions highlights the country-specific legal and institutional traditions that have shaped audit policy and therefore, would shape audit harmonization.

The remainder of this paper is organized as follows. The next section presents the background and research questions. The third section discusses the research methodology, while the fourth section presents the results of our statistical tests. The paper is concluded in section five.

BACKGROUND AND RESEARCH QUESTIONS

The AICPA has historically heralded internal control reports as way to strengthen an entity's internal control framework and reduce financial statement fraud (Cohen Commission, 1978; Treadway Commission 1987; COSO 1992). While those various

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[2] Advisory Committee on the Auditing Profession – Report dated October 6, 2008, Part VII, Firm Structure & Finances – Recommendation #5. http://www.treas.gov/offices/domestic-finance/acap/index.shtml

commissions recommended management and auditor reports on internal controls, the requirement was not mandated in the U.S. until passage of Sarbanes-Oxley in 2002[3]. So, while the reporting requirement is relatively new, the concepts and framework (i.e., COSO) associated with internal controls are well-developed in the U.S.

In France, internal control reports are mandated by article 117 of the Financial Security Act (*Loi Sécurité Financière*) of 2003 (LSF). According to the Financial Markets' Authority (*Autorité des Marchés Financiers*, AMF hereafter), these standards require the Chairman of the Board of Directors to give an account on the internal control procedures the company has implemented (AMF 2007). Article 120 of the LSF requires the external auditors to present a report of their observations of the Chairman's report regarding the processing of accounting information (AMF 2007).

The framework used to assess internal controls, however, was neither clearly defined nor mandated. In fact, companies could choose from a range of internal control frameworks as defined by COSO, AFEP/MEDEF (the joint guidelines of the French Association of Private Companies, *Association Française des Entreprises Privées*, and the French Business Confederation, *Mouvement des Entreprises de France*), CNCC (the French National Society of Auditors or *Compagnie Nationale des Commissaires aux Comptes*), and IIA/IFACI (the joint guidelines of the Institute of Internal Auditors and the French counterpart the *Institut Français des l'Audit et du Contrôle Internes*). Given the lack of a standard definition of internal control, only 33% of companies indicated the standard they used to compile their internal control report in 2005 (AMF 2006). In contrast, the PCAOB standards (AS2 and AS5 which replaced AS2) on auditor's internal control reporting mandate the use of the criteria based on COSO.

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[3] The Federal Deposit Insurance Corporation Improvement Act of 1991 is an exception requiring such reporting for all U.S. financial depository institutions with assets over $500 million.

As such, the AMF created a working group in 2005 to develop an internal control framework for use by French companies to meet the obligations of the LSF. The resulting framework uses principles set forth by COSO and the British Turnbull guidance and was written to ensure compliance with French regulations and the revised 4th, 7th, and 8th European directives. As a result, in 2008 73% of companies reference an internal control framework in their report, with the AMF framework, COSO or some combination of the two being the overwhelming framework referenced (AMF 2008).

U.S. Versus French Perceptions of Internal Control Reports

How different countries create, disclose and use accounting information has been a source of research for many years. Much of that research has focused on the legal institutions of finance—the legal origin of shareholder protection and the quality of its enforcement (La Porta et al., 1998). This topic was operationalized as the importance of equity markets using an aggregation of three variables: the ratio of aggregate stock market capitalization to gross national product, the number of listed domestic firms relative to the population and the number of initial public offerings relative to the population (La Porta et al., 1997).

This equity market importance variable is constructed such that a higher score indicates a greater importance of the stock market. It has been used in studies related to international comparisons of earnings management (Leuz et al., 2003) and differences in domestic accounting standards and International Financial Reporting Standards (Ding et al., 2007). Both studies conclude that the importance of equity markets is positively related to better quality accounting information because the information needs of outside shareholders limits insiders' incentives to manipulate accounting information.

An implication of those findings is that users of accounting information in similarly ranked countries would require similar types of information. Leuz and Verrecchia (2000) suggest that

non-U.S. firms voluntarily disclose IFRS financial information in an attempt to lower the information asymmetry component of their cost of capital. Ashbaugh (2001) finds that non-U.S. firms are more likely to disclose IFRS financial information when participating in seasoned equity offerings. Ding et al. (2007) find that divergence, not absence, from prescribed IFRS is a result of firms providing richer, firm-specific information to the capital markets.

In those studies cited above, the U.S. and France are on two ends of the spectrum related to the importance of equity markets. Leuz et al., (2003) using data from La Porta et al., (1997), which was collected in 1994, report that the U.S. has an equity market importance of 23.3, while France has an index of 9.3[4]. French capital markets, however, have been transformed since that data was collected. The country has gone through a competitive disinflation policy, forcing large firms to the market, rather than the government, for resources (Amable & Hancké, 2001). In addition, deregulation of the capital markets was initiated with the European Transparency Directive which was codified into French law in 1988. Since the codification of that directive, the pattern of shareholding has changed where the degree of bank dependence in the capital markets has declined (Kremp et al., 1999). In addition, this deregulation opened the door for foreign institutional investors (Morin, 2000).

Thus, measures of equity market importance in France have changed since 1994. We calculated a more recent equity market importance factor for this study. In 2009, the U.S. had an equity market importance factor 15.45 while France had a factor of 16.01[5]. While the French equity markets have increased in

[4] Countries higher than the U.S. are Switzerland (24.8), Malaysia (25.3), the UK (25.0), Hong Kong (28.8) and Singapore (28.8). Countries lower than France are Indonesia (4.7), Germany (5.0), Philippines (5.7), Italy (6.5), Austria (7.0), and Spain (7.2). All values are reported in Leuz et al. (2003).

[5] Data was collected for every year from 1995 to 2009 for the U.S., France and all members of the EC. Information about country population, gross domestic

importance, it would be misleading to say the U.S. and France have the same market structure. Rather, France is described as having moved from "state-managed" capitalism to "state-led" capitalism where the government still plays an active, although smaller role than in years before (Schmidt, 2003). The French approach is described as selective, based on social compromise (Lee & Yoo, 2008).

Notwithstanding the differences in market structure, equity markets are important in both the U.S. and France. As such, we would expect users of financial information in both countries to find reports on internal controls over financial reporting to be useful, since the internal control reports reduce information asymmetry between insiders and outsiders. Thus, the first research question is as follows:

> Research question 1: Do French and U.S. users' perceptions of the internal control report differ?

The Auditor's Environment

User's perceptions of an auditor's audit communication are influenced by the environment in which the auditor performs her work. Two aspects of the auditor's environment that are applicable to the internal control report are the auditor's responsibility for fraud and the auditor's liability to third parties.

The Auditor's Responsibility for Fraud Detection. The auditor's failure to meet public expectations regarding the auditor's responsibility for fraud detection is an on-going source of confusion between users and auditors (DeJong & Smith, 1984; Hooks et al., 1994) and has been documented as the source of confusion in the U.K. (Humphrey et al., 1993), Australia (Low, 1980), and New Zealand (Porter, 1983). In the U.S., similar studies have been performed that lend credibility to fraud detection

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product, and listed domestic firms was collected from the World Bank. Data about initial public offerings was collected from Bloomberg.

responsibility as the source of confusion. For example, Epstein and Geiger (1994) found that stockholders perceived auditors as providing absolute assurance against fraud. Frank et al. (2001) found significant differences between auditors and jurors regarding fraud detection. Jurors view the auditing profession as a public watchdog, actively searching for fraud. This confusion could lead to a decline in the auditor's usefulness to society (Carmichael, 2004).

Little research, however, has been devoted to user perceptions of auditor fraud detection responsibility in France. According to Jedidi and Richard (2009) French auditing research has mainly focused on audit quality (Richard, 2000), auditor independence (Mikol & Standish, 1998) and audit history (Mikol, 1993; Bocqueraz, 2000; Ramirez, 2005). One study, however, has investigated auditor responsibility for fraud detection. Carassus and Cormier (2003) found that French auditors who design their tests more in-line with U.S. fraud standards are more likely to detect fraud.

To date, no study has assessed French users' attitudes regarding the auditor's responsibility for fraud detection. This scarcity of research may be the result of the way in which auditor responsibility is written into French law. Jedidi and Richard (2009) provide a thorough review of user and auditor confusion surrounding the audit function. In their review, however, the auditor's responsibility for fraud detection is not listed as a reason for the expectation differences. In their estimation this may be because French law requires auditors who discover some breach of the law to report it to the public prosecutor. Thus, Jedidi and Richard (2009) conclude that in addition to certifying accounts, French auditors are also expected to detect fraud.

The Auditor's Responsibility to Third Parties. The auditor's legal environment, whether created through the court system or legislative branch, establishes the level of liability auditor's face as a consequence of their audit reporting. In the U.S.

an auditor's duty to third parties is a matter of state law, rather than national law (Chung et al., 2010). Each state, therefore, has the discretion to define a third party: either restrictive in that privity must exist, or open, to include all foreseeable parties. Only two states, however, use the most liberal definition of third party liability, with the overwhelming majority of states limiting who can be classified as a third party (Louwers et al., 2011). Thus, U.S. auditors are typically held responsible to the providers of capital (creditors and shareholders).

In France, the general basis for an auditor's (*commissaire aux comptes*) liability is specified in the Code Civil and is specifically regulated under article 234, section 1, of the *Loi sur les Sociėtės Commercials no. 66-537*, which was adopted in 1966 (Baker & Quick, 1996). With this codification, the auditor's status changed from contractual (individual shareholders' interest) to statutory (general interest of the public) (Khoury, 2001). Auditor liability, therefore, is broadly defined since their work is viewed to be in the public interest (Khoury, 2001). Since third parties do not have to be specifically known, France uses the most liberal definition of a third party, the reasonable foreseeability standard (Chung, et al., 2010).

An open question, therefore, is how French users will perceive explicit acknowledgement of the auditor's responsibility for fraud in an audit communication. Previous research has shown that U.S. users perceive more positively the auditor's internal control report with the inclusion of fraud wording (Foster, et al., 2010). Consequently, we present the following research question to explore non-professional users' perceptions about the auditor's fraud detection responsibility:

> Research question 2: Does the inclusion of wording referencing the auditor's responsibility for fraud detection enhance both U.S. and French users' perception of the internal control report?

METHOD

Research Questionnaire

The research questionnaire was developed as a variation of the semantic differential technique used in accounting by Haried (1972, 1973) and originally developed by Osgood et al. (1971) to measure the connotative meaning of a concept. Osgood et al. (1971) proposed that the meaning underlying a construct has three dominant dimensions. Houghton (1987, 1988) found that these three underlying dimensions applied to accounting, what Houghton and Messier (1991) identified as evaluative, obligatory, and potency. Prior studies have similarly found user perceptions of audit reports to have three stable underlying dimensions. Monroe and Woodliff (1993, 1994) identified these dimensions as responsibility, reliability and prospects, while Gay et al. (1998) referred to the dimensions as responsibility, reliability, and decisions usefulness.

In this study, the questionnaire was developed to measure perceptions of the message communicated through an auditor's internal control report. The eleven questions used were developed based on prior literature regarding audit communications (Libby 1979; Nair and Rittenberg, 1987; Kelly and Mohrweis, 1989) and has been used in prior research (e.g., Foster, et al., 2005; Foster, et al., 2010). Deriving measures used in this study from existing research helps to ensure their construct validity (O'Leary-Kelly & Vokorka, 1998). The motivation behind the *readability* dimension is to determine if U.S. and French users have differing perceptions as to the purpose of the report, and to determine if those perceptions would be reinforced or reduced by including fraud language. Kelly and Mohrweis (1989) used similar questions to assess the understandability of an audit report.

The *reliability* dimension is used to capture and compare the degree of reliance U.S. and French users have on the internal control system to produce financial statements that are not materially misstated. Additionally, to the extent in which fraud wording is more descriptive of the audit process, it could provide

more information concerning the dependability of the financial statements. Libby (1979) and Nair and Rittenberg (1987) identified a similar dimension which they referred to as the user's need for additional information and the usefulness of the financial statements, respectively.

The third dimension, *liability*, captures U.S. and French users' perceptions of the extent the auditor is assuming legal liability for the adequacy of the internal control structure. The auditor's report provides readers with an understanding as to the relative responsibilities assumed by management and the auditor.

To the extent fraud wording provides additional or new information about what an auditor is doing, it may change users' perception of the relative responsibility of auditors and management to establish and maintain a system of internal controls over financial reporting. Nair and Rittenberg (1987) and Kelly and Mohrweis (1989) measured auditor responsibility using similar questions.

Participants and Design

The data was collected in 2009 from 92 MBA students from an urban university in the Midwest area of the United States and 72 senior-level accounting/finance students from a university in the north of France. Three internal control report formats are used in this study[6]. The first, labeled AS, is the format prescribed by the PCAOB in AS2, which includes a limitations paragraph. Version two, labeled NL, is the similar to AS but does not contain a limitations paragraph. The final version, labeled FW, is similar to the NL format but contains fraud wording language (e.g., *we plan and perform an examination to obtain reasonable assurance about whether the Company's internal control is sufficient to detect/prevent material errors, irregularities, or fraud*).

[6] The three versions of the report with survey questions are in the Appendix at the end of the paper. A complete set of survey material packet items can be obtained from the authors.

The participants were asked the eleven questions using a between-subjects design since prior research has demonstrated that subjects can become oversensitive to the variables being tested with a within-subjects design (Pany and Reckers 1987). Additionally, a context-free frame of reference is used to minimize the potential confounding effects and potential biasing that including additional information about either the client or the auditor might create.

Therefore, an entire set of financial statements is not presented with the auditor's internal control report as this would have unnecessarily increased the length of the survey and potentially distracted participants' from the focus of the study. Prior studies have used this approach (Pany and Reckers, 1987; Kelly and Mohrweis, 1989; Yardley 1989; Hasan et al., 2003) and report that users did not have difficulty completing the task in a context-free framework.

Of interest in this study is the impact report format has on users' perceptions of the internal control report along the *readability, reliability* and *liability* dimensions. To test research question 1, we compare French users' perceptions to those of U.S. users' perceptions along the identified dimensions using the AS format of the report. Previous studies have shown that user perceptions can be affected by report formatting (Hasan et al., 2003) and wording changes (Bailey et al., 1983; Kelly and Mohrweis, 1989; Houghton and Messier, 1991). Therefore, we test research question 2, by comparing French and U.S. responses to the FW version of the report and compare those responses to the AS format.

Results

We initially performed a MANOVA, with Bonferroni adjustment, on the data to determine the effects of two user groups (French and U.S.) and three treatment variables (AS, NL, and FW) on three dependent variables (*readability*, *reliability,* and *liability*). The MANOVA results are summarized in Panel A of Table 1. We

find that ratings of internal control reports are affected by country (p= 0.038), not by report type (*p*= 0.328), but there is a moderately significant interaction (*p*=0.083) between country and report type.

Because MANOVA results were significant, we performed ANOVAs to analyze each of the dependent variables (*readability, reliability,* and *liability).* The ANOVA results are reported in Panels B, C, and D of Table 1. Country is significant for the *readability* (*p*= 0.028) and *liability* (*p*= 0.027) dimensions, report type is significant only for the *reliability* dimension (*p*=0.051), and the interaction term is significant in the *readability* (*p*= 0.070) and *reliability* dimension (*p*= 0.011).

Table 1
MANOVA and ANOVA results

Panel A: multivariate analysis of variance

Effect	Wilks' Lambda	F-Statistic	*p*-Value
Country	0.95	2.88	0.038
Report type	0.96	1.16	0.328
Interaction	0.93	1.89	0.083

Panel B: ANOVA results for the readability dimension

Effect	Mean square	F-value	*p*-Value
Country	5.84	4.92	0.028
Report type	2.19	1.84	0.162
Interaction	3.22	2.71	0.070

Panel C: ANOVA results for the reliability dimension

Effect	Mean square	F-value	*p*-Value
Country	0.52	0.52	0.474
Report type	2.98	3.03	0.051
Interaction	4.59	4.66	0.011

Panel D: ANOVA results for the liability dimension

Effect	Mean square	F-value	*p*-Value
Country	4.89	4.93	0.027
Report type	0.29	0.30	0.743
Interaction	0.08	0.08	0.927

Notes. Country refers to user group, either U.S. or French and report type refers to one of three report formats (AS = internal control report format established by the PCAOB; NL = the AS internal control report format without a limitations paragraph; and FW = the NL internal control report format incorporating fraud wording).

We use univariate results to identify the specific differences in mean ratings of the internal control report formats between U.S. and French users, summarized in Table 2. Panel A of Table 2 indicates that significant differences exist between U.S. and French users in the *readability* dimension when the report format includes fraud wording ($p<0.05$). Inclusion of the auditor's responsibility for fraud also significantly increases U.S. users' *readability* rating when compared to the AS format ($p<0.05$). Panel B of Table 2 presents similar results for the *reliability* dimension. With respect to the FW report incorporating fraud wording, the differences in mean ratings for *readability* and *reliability* between U.S. and French users differ significantly ($p<0.10$) and for U.S. users the difference in mean ratings between the FW and AS format is significant ($p<0.05$). These results indicate that U.S. users rate significantly more favorably the FW format than their French counterparts and also more favorably than the AS format.

Panel C of Table 2 indicates there are no significant differences between U.S. and French users along the *liability* dimension. While the purpose of this paper is not to test the efficacy of a limitations paragraph, analyses do include a comparison of the AS and FW formats to the NL format. Tests indicate no significant difference between the AS and NL format or the NL and FW format. Thus, we conclude that the limitations paragraph is not driving any of the results we report.

Summarizing the data, we find no differences between the U.S. and French users' perceptions of the internal control report when comparing responses related to the AS report format. These findings suggest that an auditor's internal control report could provide value to user groups outside the U.S. By comparison, U.S. and French users differ significantly along the *readability* and *reliability* dimensions when comparing an auditor's internal control report that contains fraud wording. This increase in U.S. perceptions' of the report may be because U.S. users' desire for auditor's to detect fraud and explicit acknowledgement of that responsibility provides comfort to readers of audit reports. In

contrast, French users' perception did not change when comparing different report formats perhaps because auditor responsibility for fraud detection is codified into law and fully expected regardless of the wording in the audit report.

Table 2
Bonferroni pairwise comparison of mean responses
(92 U.S. and 72 French subjects)

Panel A: Readability dimension

	Report type means (std. dev.)			Difference		
Country	AS	NL	FW	AS-NL	AS-FW	NL-FW
U.S.	4.74	4.97	5.55	0.23	0.81**	0.61
	(1.25)	(0.92)	(1.31)			
France	4.62	4.89	4.60	0.27	0.02	0.29
	(0.99)	0.99)	(0.93)			
Difference	0.12	0.08	0.95**			

Panel B: Reliability dimension

	Report type means (std. dev.)			Difference		
Country	AS	NL	FW	AS-NL	AS-FW	NL-FW
U.S.	4.12	4.54	5.16	0.42	1.04**	0.62
	(1.06)	(0.95)	(1.16)			
France	4.57	4.47	4.45	0.10	0.12	0.02
	(0.98)	(0.90)	(0.80)			
Difference	0.45	0.07	0.71*			

Table 2 -continued
Panel C: Liability dimension

	Report type means (std. dev.)			Difference		
Country	AS	NL	FW	AS-NL	AS-FW	NL-FW
U.S.	3.81	3.79	3.65	0.02	0.16	0.14
	(1.11)	(0.95)	(1.17)			
France	4.19	4.05	4.05	0.14	0.14	0.00
	(1.00)	(0.92)	(0.62)			
Difference	0.38	0.26	0.40			

Notes. AS = internal control report format established by the PCAOB; NL = the AS internal control report format without a limitations paragraph; and FW = the NL internal control report format incorporating fraud wording.
*Significant at *p*-value <0.10 for one tailed test
** Significant at *p*-value <0.05 for one tailed test

CONCLUSION

The harmonization between U.S. GAAP and International Financial Reporting Standards has been the focus of much attention in recent years (for example, Hail et al., 2010a, 2010b; Daske et al., 2008; Bradshaw, et al., 2010). Less quietly, however, there has been an ongoing project between the AICPA and IAASB to harmonize auditing standards. Therefore, we extend the literature on accounting harmonization by studying audit harmonization. In particular, we compared data related to U.S. and French users' perceptions of the auditor's report on internal control of financial reporting along the *readability*, *reliability*, and *liability* dimensions. Specifically, we investigated whether the two groups evaluated the report similarly and to what extent the inclusion of fraud wording enhanced the users' perception of the report.

Our study's findings make at least two important contributions to the ongoing policy debate regarding the harmonization of audit standards. First, our results indicate that

U.S. and French users rate the PCAOB AS2 (replaced by AS5) required internal control report similarly, with no significant differences along the three dimensions. These results suggest that U.S. and French users have similar information needs (not surprising given the increasing importance of French equity markets over the last 15 years) and thus, auditor's internal control report could potentially be value-relevant for non-U.S. users.

Second, we found that the inclusion of fraud wording increased positively/favorably U.S. users' perceptions of the report along the *readability* and *reliability* dimensions, but had no significant impact on French user perceptions. These results suggest that fraud wording in an internal control report does not favorably increase French users' perceptions, but does favorably increase U.S. users' perceptions of the *readability* and *reliability* (audit assurance) dimensions of such a report format (possibly due to U.S. users' sensitivity to fraud caused by some of the accounting scandals, such as Enron, WorldCom). These results are not surprising because French auditors are legally required to report instances of fraud to a public prosecutor (Jedidi & Richard, 2009). Thus, from a French perspective, inclusion of fraud wording may be considered redundant because of a societal expectation that French auditors actively search and detect fraud. In contrast, some of the major accounting scandals around the turn of the century (e.g., Enron, Worldcom) appear to have influenced U.S. users to believe that fraud detection should be an explicit part of the auditors' responsibility.

Finally, recognition/inclusion of the auditor's fraud detection responsibility into the auditor's internal control report (FW format) does not appear to increase perceptions regarding auditor liability for either user group. These results are not surprising given the legal environment in the U.S. and the definition of third party used in France. That is, users may perceive legal liability at an already high level because of the litigious nature of a society or by the standards used to define to whom the auditor owes liability.

Our research is limited, however. First we use MBA and senior undergraduate (accounting/finance) students in our sample. While Frederickson and Miller (2004) found significant differences between professional investors and non-professional investors in the assignment of stock prices based on pro forma and GAAP disclosures, Elliot et al. (2007) found that students make judgments consistent with non-professional investors when the experiment was not an investment decision and had low integrative features. Furthermore, in real-world decision contexts, subjects would be performing with different pressures, motivations and a broader information set.

Second, our sample is relatively small and consisted of participants from limited geographic areas. Future studies could broaden coverage by investigating similar perceptual processes related to audit communications in other European countries and other continents. In addition, it is not known if the perceptions of our sample are reflective of other potential nonprofessional users of an auditor's internal control report. With that said, however, the results should be generalizable and useful in policy debates because of the relatively less complex nature of the task used for experimental manipulation.

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APPENDIX

Report formats used for experimental manipulation: AS, NL & FW

AS—Format

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of ABC Company

We have audited management's assessment, included in the accompanying Management Report on internal control, that ABC Company (the "Company") maintained effective internal control over financial reporting as of December 31, 20X5, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other

procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements on a timely basis. Also, projections of any evaluation of the effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 20X5, is fairly stated, in all material respects, based on the criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X5, based on

the *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheet of the company as of December 31, 20X5, and the related statements of income, shareholders' equity, and cash flows for the year ended December 31, 20X5 of the Company and our report dated February 28, 20X6 expressed an unqualified opinion on those financial statements.

Signed: XYZ & Co, CPAs, February 28, 20X6

NL—Format

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of ABC Company

We have audited management's assessment, included in the accompanying Management Report on internal control, that ABC Company (the "Company") maintained effective internal control over financial reporting as of December 31, 20X5, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 20X5, is fairly stated, in all material respects, based on the criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, the

Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X5, based on the *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheet of the company as of December 31, 20X5, and the related statements of income, shareholders' equity, and cash flows for the year ended December 31, 20X5 of the Company and our report dated February 28, 20X6 expressed an unqualified opinion on those financial statements.

Signed: XYZ & Co., CPAs, February 28, 20X6

FW—Format

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of ABC Company

We have audited management's assessment, included in the accompanying Management Report on internal control, that ABC Company (the "Company") maintained effective internal control over financial reporting as of December 31, 20X5, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements; and (4) provide reasonable assurance regarding prevention or timely detection of error or fraud that could have a material effect on the financial statements.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 20X5, is fairly stated, in all material respects, based on the criteria established in *Internal Control-Integrated*

Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting to provide reasonable assurance regarding prevention or timely detection of error or fraud as of December 31, 20X5, based on the criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheet of the company as of December 31, 20X5, and the related statements of income, shareholders' equity, and cash flows for the year ended December 31, 20X5 of the Company and our report dated February 28, 20X6 expressed an unqualified opinion on those financial statements, which were free of material misstatements due to error or fraud.

Signed: XYZ & Co., CPAs, February 28, 20X6

Survey Questions

Readability dimension

1. The message communicated by the above independent accountant's report (on ABC Company's internal control structure) is **completely understandable**.
3. The purposes of the audit of ABC Company's internal control structure are **clearly communicated** in the above independent accountant's report.

Reliability Dimension

2. How **confident** are you that ABC Company's internal control structure is capable of producing financial statements **free of material errors** for the year 19X8?
5. How **confident** are you that ABC Company's internal control structure is capable of producing financial statements **free of**

material misstatements due to an irregularity for the year 19X8?

7. How **confident** are you that ABC Company's internal control structure is capable of producing financial statements **free of material misstatements due to fraud** for the year 19X8?
10. From the above independent accountant's report, it can be concluded that ABC Company's internal control structure is capable of producing financial statements **free of material misstatements** for the year 19X8.
11. The **degree of assurance** about the reliability of ABC Company's internal control structure provided by the above independent accountant's report is higher.

Liability dimension

4. The **likelihood** that the above independent accountant's report will expose the independent accountant (auditor) of ABC Company to **legal liability** is higher.
6. The **likelihood** that the above independent accountant's report on (ABC Company's internal control structure) will lead to a **lawsuit** against the independent accountant (auditor) of ABC Company is higher.
8. By issuing the above independent accountant's report, the independent accountant (auditor) of ABC Company assumes **a great amount of risk.**
9. It is clear from the above independent accountant's report (on ABC Company's internal control structure) that the independent accountant (auditor) of ABC Company is assuming a **high degree of responsibility.**