

ESSAYS ON AUDITORS' AND FINANCIAL REPORTING

- The impact of non-financial disclosures on stakeholders' perceptions -

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vorgelegt von

Michelle Höfmann

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Table of Content

List of Figures	V
List of Tables.....	VI
List of Abbreviations.....	VII
1. Introduction	1
2. The Effects of Key Audit Matters and Stock Ownership on Audit Committee Members' Decision Making.....	7
2.1 Publication Details.....	7
2.2 Introduction	8
2.3 Theoretical Background and Hypotheses.....	12
2.3.1 Recent Research on KAMs	12
2.3.2 Development of hypotheses	14
2.4 Research Design.....	17
2.4.1 Administration.....	17
2.4.2 Experiment Task and Materials.....	17
2.4.3 Variables.....	19
2.4.4 Participants and Manipulation Checks	19
2.5 Results.....	21
2.5.1 Test Results	21
2.5.2 Post-experiment debriefing items.....	24
2.6 Conclusion	25
2.7 Appendix.....	28
3. Key Audit Matters: Qualitätssteigerung für den Bericht des Aufsichtsrats? – Eine empirische Analyse der Aufsichtsratsberichte der DAX-, MDAX- und SDAX-Unternehmen 2017 –	32
3.1 Publikationsdetails.....	32
3.2 Einleitung	33

3.3	Die Rolle des Aufsichtsrats im Rahmen der Jahresabschlussprüfung	34
3.3.1	Theoretische Fundierung mithilfe der Principal-Agent-Theorie.....	34
3.3.2	Bericht des Aufsichtsrats.....	35
3.3.3	Bisherige empirische Forschungsergebnisse.....	36
3.4	Der neue Bestätigungsvermerk gem. IDW PS 400 n.F.	38
3.5	Bedeutung der KAM für den Bericht des Aufsichtsrats.....	40
3.6	Empirische Analyse	41
3.6.1	Zielsetzung	41
3.6.2	Stichprobe.....	42
3.6.3	Methodische Vorgehensweise.....	42
3.6.4	Ergebnisse	44
3.7	Kritische Würdigung der Untersuchung.....	49
3.8	Zusammenfassung	50
4.	Informationsmehrwert oder Standardbericht? – Die Entwicklung der KAM-Berichterstattung in Deutschland –	53
4.1	Publikationsdetails.....	53
4.2	Einleitung	54
4.3	Rechtliche Grundlagen.....	55
4.4	Empirische Analyse	56
4.4.1	Datengrundlage	56
4.4.2	Ergebnisse	57
4.4.2.1	Anzahl der KAM.....	57
4.4.2.2	Verschiedenheit der KAM	60
4.4.2.3	Textähnlichkeit der KAM	65
4.5	Zusammenfassung und Ausblick	69
5.	The impact of audit report expansions and audit committee strength on bank directors' perceptions and decisions: An experimental investigation	72

5.1	Publication Details.....	72
5.2	Introduction	73
5.3	Background, prior research, and development of hypotheses	77
5.4	Research Design.....	83
5.4.1	Experiment	83
5.4.2	Participants	85
5.5	Results	89
5.6	Conclusion.....	98
5.7	Appendix	101
6.	Berichterstattung von Aufsichtsrat und Vorstand - „Der Ton macht die Musik“: eine textimmanente Analyse.....	105
6.1	Publikationsdetails.....	105
6.2	Einleitung	106
6.3	Die Berichterstattung von Aufsichtsrat und Vorstand	107
6.3.1	Der Bericht des Aufsichtsrats.....	108
6.3.2	Brief des Vorstands	108
6.4	Empirische Untersuchung	109
6.4.1	Datengrundlage und Vorgehen.....	109
6.4.2	Textlänge	110
6.4.3	Lesbarkeit	113
6.4.3.1	Quantifizierung von Lesbarkeit	113
6.4.3.2	Empirische Analyse der Lesbarkeit	115
6.4.4	Stimmung (Sentiment)	117
6.4.4.1	Quantifizierung von Stimmung.....	117
6.4.4.2	Empirische Analyse der Stimmung	118
6.5	Zusammenfassung	119
7.	Conclusion.....	121

8. References 123

List of Figures

Figure 2.1: Interaction Term 23

Abbildung 3.1: Auswahlprozess der KAM nach IDW PS 401, Abb. 1 39

Abbildung 3.2: Themen der im Bericht des Aufsichtsrats angesprochenen KAM 47

Abbildung 4.1: Bestimmung und Mitteilung besonders wichtiger Prüfungssachverhalte 56

Abbildung 4.2: Anzahl der KAM im Jahresvergleich 58

Abbildung 4.3: Entwicklung der durchschnittlichen Anzahl der KAM nach Börsenindex und prüfender Wirtschaftsprüfungsgesellschaft 59

List of Tables

Table 2.1: Demographic items	21
Table 2.2: Results	22
Tabelle 3.1: Kategoriensystem	43
Tabelle 3.2: Berichterstattung über KAM im Bericht des Aufsichtsrats	44
Tabelle 3.3: Art der Berichterstattung über KAM	45
Tabelle 4.1: Stichprobenauswahl	57
Tabelle 4.2: Beispiel zur Berechnung der VERSCHIEDENHEIT	62
Tabelle 4.3: Verschiedenheit der KAM-Themenfelder (differenziert nach Indexzugehörigkeit)	63
Tabelle 4.4: Verschiedenheit der KAM-Themenfelder (differenziert nach Prüfungsgesellschaften)	64
Tabelle 4.5: Verschiedenheit der KAM-Themenfelder (differenziert nach Prüferwechsel)....	65
Tabelle 4.6: Beispiel zur Ermittlung der Textähnlichkeit zweier Texte	66
Tabelle 4.7: Textähnlichkeit der KAM-Berichterstattung (differenziert nach Prüferwechsel)	68
Table 5.1: Demographic items	87
Table 5.2: Number of participants per experimental condition	89
Table 5.3: Means and standard deviations of dependent variables by experimental conditions	90
Table 5.4: Means and standard deviations of dependent variables by factor levels	91
Table 5.5: Results for the dependent variable RELY.....	92
Table 5.6: Results for the dependent variable LOAN.....	93
Table 5.7: Results for the dependent variable ADVICE.....	94
Table 5.8: Results for the dependent variable INVEST.....	95
Table 5.9: Results for the dependent variable GOING_CONCERN.....	96
Table 5.10: Results for the dependent variable ECONOMIC_SITUATION	97
Tabelle 6.1: Endgültige Stichprobe	110
Tabelle 6.2: Zahl der Wörter im Zeitablauf	111
Tabelle 6.3: Zahl der Wörter nach Indizes (2018)	112
Tabelle 6.4: LIX-Werte im Zeitablauf	115
Tabelle 6.5: LIX-Werte nach Indizes (2018)	115
Tabelle 6.6: Sentiment im Zeitablauf.....	118

List of Abbreviations

a.a.O.	am angeführten Ort
Abb.	Abbildung
AblEU	Amtsblatt der Europäischen Union
Abs.	Absatz
AC	Audit Committee
AG	Aktiengesellschaft
AktG	Aktiengesetz
ANCOVA	Analysis of Covariance
ANOVA	Analysis of Variance
AR	Zeitschrift „Der Aufsichtsrat“
AreG	Abschlussprüfungsreformgesetz
Art.	Artikel
BFuP	Zeitschrift „Betriebswirtschaftliche Forschung und Praxis“
BilMoG	Bilanzrechtsmodernisierungsgesetz
bspw.	beispielsweise
bzw.	beziehungsweise
CAM(s)	Critical Audit Matter(s)
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CRR	Capital Requirements Regulation
CSR	Corporate Social Responsibility
DAX	Deutscher Aktienindex
DB	Zeitschrift „Der Betrieb“
DCGK	Deutscher Corporate Governance Kodex
EBIT	Earnings before interest and taxes
EC	European Commission
et al.	et alia/und andere
e.g.	exempli gratia/for example
EG	Europäische Gemeinschaft
EU	Europäische Union
EUR	Euro
EU-VO	Verordnung der Europäischen Union

EY	Ernst & Young
f.	folgende
Fn.	Fußnote
FRC	Financial Reporting Council
FTSE	Financial Times Stock Exchange
GC-EOM	going concern emphasis of matter paragraph
GCU	going concern uncertainty
ggf.	gegebenenfalls
GmbH	Gesellschaft mit beschränkter Haftung
grds.	grundsätzlich
H	Hypothese
HGB	Handelsgesetzbuch
h.M.	herrschende Meinung
Hrsg.	Herausgeber
IAASB	International Auditing and Assurance Standards Board
i.d.F.	in der Fassung
i.d.R.	in der Regel
IDW	Institut der Wirtschaftsprüfer in Deutschland e.V.
i.e.	id est
IFRS	International Financial Reporting Standards
insb.	insbesondere
IRZ	Zeitschrift für Internationale Rechnungslegung
ISA	International Standard on Auditing
i.S.d.	im Sinne des
JOA	Justification of Assessments
KAM(s)	Key Audit Matter(s)
KGaA	Kommanditgesellschaft auf Aktien
KoR	Zeitschrift für internationale und kapitalmarktorientierte Rechnungslegung
KWG	Kreditwesengesetz
MDAX	Mid-Cap-DAX
Mio.	Millionen
n.F.	neue Fassung

Nr.	Nummer
OLG	Oberlandesgericht
PCAOB	Public Company Accounting Oversight Board
PIE	Public Interest Entities
PS	Prüfungsstandard
PwC	PricewaterhouseCoopers
p-value	probability value
RL	Richtlinie
Rn.	Randnummer
RWZ	Zeitschrift für Recht und Rechnungswesen
S.	Seite
SDAX	Small-Cap-DAX
SE	Societas Europaea
S.E.	Standard Error
Sec.	Section
sog.	sogenannt
Tab.	Tabelle
Tz.	Textziffer
u.a.	unter anderem
U.K.	United Kingdom
vgl.	vergleiche
Vol.	Volume
vs.	versus
WPg	Zeitschrift „Die Wirtschaftsprüfung“
z.B.	zum Beispiel
ZCG	Zeitschrift für Corporate Governance
zfbf	Schmalenbachs Zeitschrift für betriebswirtschaftliche Forschung

1. Introduction

For decades, the improvement of the auditor's report was discussed worldwide by institutions as the International Auditing and Assurance Standards Board (IAASB) and the Public Company Accounting Oversight Board (PCAOB). The opinion in the former auditor's report was communicated in a "pass or fail"-statement and therefore criticized by investors and other stakeholders due to its lack of communicative value. In order to improve the auditor's report by enhancing its communicative value, the disclosure of key audit matters (KAMs) became compulsory for public interest entities (PIE).¹ Key audit matters are defined as "those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance." (IAASB 2015c, paragraph 8). Hence, communicating key audit matters provides greater additional information about the audit that was performed and shall increase the auditor's report's informational value for investors.

Prior research investigates the effects this new regulation has on auditors as they select and describe these matters and disclose their reaction to them, making the audit process more transparent to the public. Hence, KAMs might increase or reduce auditor liability due to increased transparency of the audit (Brasel, Doxey, Grenier, and Reffett 2016; Gimbar, Hansen, and Ozlanski 2016a; Vinson, Robertson, and Cockrell 2019). Another branch of research focuses on investors as addressees of the auditor's report, investigating the real informational value of the KAM section and its decision usefulness for them (Christensen, Glover, and Wolfe 2014; Sirois, Bédard, and Bera 2018; Bédard, Gonthier-Besacier, and Schatt 2019; Köhler, Ratzinger-Sakel, and Theis 2020), yielding different results.

Besides the auditors and the investors, KAMs might also have effects on the decision making of a firm's representatives as the management or the supervisory board (Kang 2019; Gold, Heilmann, Pott, and Rematzki 2020; Bentley, Lambert, and Wang 2021). Because existing research relating to this topic is extendable and many open research questions remain, this dissertation contributes to existing research relating to the effects

¹ International Standard on Auditing (ISA) 701 deals with the responsibility to communicate key audit matters in the auditor's report. It became effective for audits of financial statements for periods ending on or after December 15, 2016.

of KAM disclosure on a company's board of directors. Therefore, two research studies are presented in the first and second paper of this dissertation focusing on the effects of KAM disclosure on the supervisory board, respectively the audit committee, of a company.

Hence, the *first* paper of this dissertation ("The Effects of Key Audit Matters and Stock Ownership on Audit Committee Members' Decision Making") examines whether the effects of KAM disclosure on audit committee members decision making depend on their financial independence. We conducted a 2-x-2 between-subjects experiment involving 52 incumbent or erstwhile acting non-executive directors to measure their decision making in case of an accounting disagreement between the management and the company's auditor, manipulating KAM disclosure and financial independence. If a related KAM is disclosed in the auditor's report, we assume a different decision-behavior between stock-owning and non-stock-owning directors. Based on the theories of social responsibility and helping behavior, we assume that audit committee members generally act in the investors' interest due to their function of monitoring and their duty to oversee the financial reporting and auditing process.

As KAMs in the auditor's report get more attention from investors (Sirois, Bédard, and Bera 2018), they increase directors' financial statement accountability towards investors, so that the directors tend to agree less with the management's income-increasing financial reporting decisions if the disputed issue is disclosed as a KAM than if it is not. However, we assume a different decision-behavior for stock-owning directors, as this group has, despite its oversight duty, an interest in maximizing the company's profit in order to maximize their personal outcome. Based on moral licensing theory, which claims that KAMs can serve as disclaimer indicating a forewarning effect (Asbahr and Ruhnke 2019; Ratzinger-Sakel and Theis 2019; Kachelmeier, Schmidt, Rimkus, and Valentine 2020), we assume that stock-owning directors tend to agree more with the management's income-increasing financial reporting decisions if the disputed issue is disclosed as a KAM than if it is not. Our findings support these predictions significantly, confirming that the effects of KAM disclosure also depend on financial independence of the responsible persons.

As a corollary to this research confirming that KAMs influence the decision-behavior of the supervisory board, it may be assumed that its reporting is also affected by KAM disclosure. In Germany, under a two-tier regime, the supervisory board has the duty to

report annually about the result of its audit of the company's financial statement management in a so-called report of the supervisory board (Sec. 171 (2) of the German Stock Companies Act). Because the supervisory board authorizes an external auditor with the audit of the annual financial statement and "key audit matters are selected from matters communicated with those charged with governance" (IAASB 2015c, paragraph 8), it is likely that KAMs are also focused in the report of the supervisory board. Using the supervisory board's report as „instrument of investor relations“, KAMs could serve as evidence for good and complete monitoring.

Therefore, in the *second* paper („Key Audit Matters: Qualitätssteigerung für den Bericht des Aufsichtsrats? – Eine empirische Analyse der Aufsichtsratsberichte der DAX-, MDAX- und SDAX-Unternehmen 2017“), we investigate whether KAM disclosure implies an increase of reporting quality. We use content analytical methods to analyze the report of the supervisory board of German companies listed in the DAX, MDAX and SDAX in 2017 with regard to issues that were determined as KAMs in the auditor's report. Our analysis manifests an extensive room for improvement - in most cases, it is only said that the audit committee has dealt with the topics declared as KAMs, disclosing no further information that could offer an additional value to investors or other stakeholders. Overall, in the first year of mandatory KAM disclosure, the quality of the supervisory board's report has not increased.

Generally, ISA 701 claims that "the purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed" (IAASB 2015c, paragraph 2). However, concerns from regulators and investors remain that the informational value of KAMs is limited if standardized and nonfirm-specific KAM disclosures become established. In this case, the KAMs section in the auditor's report were just another standardized section in the auditor's report and would consequently not provide any added value to the former pass/fail model (Gold, Heilmann, Pott, and Rematzki 2020).

Hence, the *third* paper („Informationsmehrwert oder Standardbericht? - Die Entwicklung der KAM-Berichterstattung in Deutschland -“) deals with the practical implementation of KAM-disclosure in Germany in order to find out whether KAMs in fact increase the informational value of the auditor's report. The auditor's reports of 141 companies of the first two mandatory years of KAM-disclosure in Germany (2017 and 2018) are analyzed with regard to number of KAMs, topical differences over the years and similarities in

wording. Concerning the topical differences, a variable was designed in order to measure the difference between the topics over the years. The results show that in the auditor's reports of 56 companies (39,7%), exactly the same topics were chosen as KAMs in both years, while the mean of difference is 20%. In case the same topics were chosen over the years, the wording of the KAMs is also quite similar. In case content and wording of KAMs remain the same over the years, the potential to create an individual auditor's report and provide decision useful information to addressees for each company in every financial year is not used. Hence, the objective of the standard setters to improve the informational value of the auditor's report was, at least in the first mandatory years, not achieved.

While the disclosure of KAMs was one fundamental amendment of disclosure to improve the informational value of the auditor's report, there was also a new regulation for going concern audit reports with the revision of the International Standard on Auditing (ISA) 570. For audits of financial statements for periods ending on or after December 15, 2016, in case there exists a material uncertainty for the entity to continue as a going concern, the auditor has to add a separate section to the auditor's report, drawing attention to the note in the financial statements that discloses this uncertainty and indicating that a material uncertainty exists (IAASB 2015a, paragraph 22).

It is disputable whether this addition has an effect on auditor's reports' addressees, because the information is also disclosed in the notes to the financial statements and is just repeated in this section. Usually, the market only reacts to new information, that is why the going concern emphasis of matter paragraph (GC-EOM) could not be informative at all.

Therefore, the *fourth* paper ("The impact of audit report expansions and audit committee strength on bank directors' perceptions and decisions: An experimental investigation") examines experimentally whether audit report expansions – a going concern emphasis-of-matter paragraph (GC-EOM), information on the management and auditor's responsibilities – and the characteristics of the audit committee do have an impact on the decision making of auditor's reports' addressees, or not. German bank directors as highly knowledgeable people participated in this experiment, representing creditors, investors and financial intermediaries at the same time. By manipulating the disclosure of a GC-EOM and a responsibilities paragraph as well as the strength of the audit committee, we investigated the impact of these factors on the bank directors' decisions as to grant loans,

make personal investments or recommend share purchase to customers. Furthermore, we focused on their reliability on the financial statements, the ability to continue as a going concern and the economic situation of the company. The results provide strong evidence for the decision usefulness of the GC-EOM in the auditor's report due to a source credibility effect. Hence, the IAASB's purpose of the revision of ISA 570 to enhance the informational value and decision usefulness of the auditor's report was achieved. However, the disclosure of a responsibilities paragraph or the strength of the audit committee do not have any significant impacts on the bank directors' perceptions and decisions.

Not only the auditor's report is of high interest to investors and therefore an important area of research, but also the communication of a company's representatives. While balance sheet and income statement are the quantitative core of the financial statements, the qualitative reporting became also more important over the years. As such, the report of the supervisory board and the letter to the shareholders get more and more used as instruments of good corporate governance to communicate with the share- and stakeholders. In this connection it is not only important *what* is communicated, but also *how*, to guarantee good and precise communication. For example, prior research proved a positive correlation between the readability of financial reports and a company's future performance (such as trading volume, earnings management activities) (Li 2008; Miller 2010; Lawrence 2013; Lo, Ramos, and Rogo 2017). For this reason, an emergent field of research focuses on textual aspects of reporting in order to analyze their impact on addressees.

Contributing to this research area, in the *fifth* paper of this dissertation ("Berichterstattung von Aufsichtsrat und Vorstand. "Der Ton macht die Musik": eine textimmanente Analyse"), the reports of the supervisory board and the letters to the shareholders of German companies listed in the DAX and MDAX are analyzed concerning their text length, readability and sentiment over the time. Hereby it is possible to both reveal the development of these reports over the time (2008, 2013, 2018), and highlight potential differences between the two instruments. The results of this study reveal extensive room of improvement concerning the language of these instruments. While the length of both of them increased over the years, the readability did not improve considerably and is still difficult. Regarding the sentiment, it was more positive for the letters to the shareholders than the reports of the supervisory board. All in all, management and the supervisory

board should be aware of the chances a good and easy understandable communication implies, whereas ineffective communication can have negative consequences.

To conclude, the present dissertation contributes to the current debate on auditor's reporting. While recent research yielded different results to the impact of KAM reporting on different stakeholders, it is necessary to extend existing research in order to acquire more consistent results. Our findings show that the impact of KAM reporting also depends on factors of financial independence of the responsible persons. However, there exists room for improvement with regard to the practical implementation in Germany due to similarities in topics and wording. To enhance the report's communicative value, KAM reporting has to be individual for each company in every business year. Additionally, we confirm the effectiveness of the new going concern emphasis of matter paragraph in the auditor's report, changing bank directors' decision making.

This dissertation is a cumulative work consisting of the following five individual papers. Please note that some papers are already published (chapter 3, 4 and 6) or under review (chapter 2 and 5). Therefore, it is likely that further modifications of individual paper versions presented in this dissertation will take place afterwards. Later versions of the papers will be available in the respective journals or at scientific platforms after publication. Thus, please make sure to cite only the latest versions of the papers.

2. The Effects of Key Audit Matters and Stock Ownership on Audit Committee Members' Decision Making

2.1 Publication Details

Abstract: This paper investigates, in an experimental setting, the (interactive) effect of key audit matters (KAMs) and stock ownership on the decision making of audit committee members in an accounting disagreement between the management and the auditor. Our findings suggest that stock-owning directors are more likely to agree with the management's income-increasing approaches in an accounting issue in the presence of KAMs than in their absence. In contrast, our results indicate higher agreement of non-stock-owning directors with the external auditor's conservative approach in case KAMs exist. Hence, our study provides evidence that the effects of disclosed audit insights on decision making related to an accounting disagreement depend on the factors of financial independence.

Co-Author: Prof. Dr. Christiane Pott

Keywords: audit report, key audit matters, audit committee, director stock ownership, financial reporting quality.

Publication Status: Revise and resubmit (2nd round review) at *AUDITING: A Journal of Practice & Theory*.

The idea of the paper is based on my master thesis submitted at the Chair of International Accounting and Auditing (TU Dortmund University), March 2017.

2.2 Introduction

The auditor's report was generally criticized by investors due to its lack of worthwhile communicative value. The only information it gave was the auditor's opinion in a pass (in most cases) or fail verbal style, without any further information on the audit. Prior research has examined the informational value of these reports and explored improved solutions (Chong and Pflugrath 2008; Church, Davis, and McCracken 2008; Gold, Gronewold, and Pott 2012; Mock et al. 2013; Boolaky and Quick 2016). In response, standard setters around the world started an initiative to improve auditors' reports by adding useful information for the addressees (European Parliament and the Council of the European Union 2014). One of these extensions is that auditors of public interest entities (PIE) must reveal key audit matters (KAMs) in their report.² KAMs are defined as 'those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period' (IAASB 2015c, 11 (a)). Thus, KAMs can enhance the informational value of the auditor's report. In Germany, ISA 701 (Communicating Key Audit Matters in the Independent Auditor's Report) and the EU Audit Reform obligate the auditors of PIE to report KAMs in their report.

This regulatory change might have implications not only for the auditor, who is identifying and describing these matters, but also for investors, the management, board of directors, and other stakeholders. In this study, we focus on the audit committee (AC) as part of the supervisory board of a company. The AC is an important part of corporate governance, as it supports the board of directors by monitoring the accounting and the audit (DeZoort, Hermanson, Archambeault, and Reed 2002). The external auditor communicates the main aspects and results of the audit to the AC of a company as a key counterpart. Therefore, the AC is of particular interest when dealing with questions of corporate governance.

Prior research studying the effects of KAMs³ focuses on the informational value of auditors' reports for professional and non-professional investors (Sirois, Bédard, and Bera 2018; Lennox, Schmidt, and Thompson 2019; Köhler, Ratzinger-Sakel, and Theis 2020)

² This amendment to auditor reporting was established by standard setters and audit regulators worldwide as the International Auditing and Assurance Standards Board (IAASB), the Public Company Accounting Oversight Board (PCAOB), the European Commission (EC) and the Financial Reporting Council (FRC).

³ Similar instruments are *critical audit matters* (CAMs) in the United States and *justification of assessments* (JOA) in France.

or the usefulness of KAMs for investors in making decisions (Christensen, Glover, and Wolfe 2014). Gold, Heilmann, Pott, and Rematzki (2020) and Bentley, Lambert, and Wang (2021) focus on the effects of disclosing KAMs on the managers' decision behavior, while Kang (2019) investigates the effects of Critical Audit Matters (CAMs) and investor sophistication on AC members' behaviors. Therefore, research focusing on the effects of KAMs on AC members' behavior is extendable.⁴ Here, we focus on the effects of KAMs on decision making by non-executive directors, especially the AC of a company, to extend the existing literature. We developed our hypotheses based on research in the field of behavioral psychology to explain the cognitive patterns responsible for specific decision-making behavior (Köhler and Quick 2018).

Generally, AC members have the duty to monitor and review the accounting and auditing process on behalf of the shareholders. Following the theories of helping behavior and social responsibility norm, AC members protect investors' interests, because they feel accountable to investors due to their function as an oversight institution. Assuming that investors' interests conform to the external auditor's critical attitude, the AC is more likely to support the auditor's point of view in case of an accounting disagreement between the auditor and the management. The disclosure of KAMs increases the financial statement accountability of AC members toward investors, because they are aware that KAMs gain investors' attention and might influence their decisions. Thus, their sense of being responsible for the reasonability and reliability of the financial statements, especially the issues published as KAMs, is stronger under these circumstances (Sirois et al. 2018; Kang 2019).

There are factors other than KAMs that might influence directors' decision making. On the one hand, specific characteristics of personality, such as overconfidence or narcissism, impact the decision making of a firm representative (Young, Du, Dworkis, and Olsen 2016). On the other hand, external factors such as independence or corporate governance experience also influence decisions (DeZoort and Salterio 2001; Bédard, Chtourou, and

⁴ To our best knowledge, the only studies concerning key audit matters that focus on the audit committee are (1) the experimental study by Kang (2019), focusing on the joint effect of investor sophistication and the prospect of CAM disclosure on AC members' propensity to ask challenging questions about management's significant accounting estimates and (2) an archival study, finding that firms with a higher percentage of women on audit committees have higher readability of KAM disclosures (Velte 2018).

Courteau 2004). In this study, we focus on financial independence as the second factor influencing decision making.

In line with prior research, we define financial independence as not owning stocks of the company for which one serves as a member of the AC, thereby remaining financially unaffected by the company's performance (Bédard et al. 2004). We, therefore, use stock ownership as a proxy for directors' (financial) dependence.

Prior research on independence related to stock ownership shows different results regarding its effects. On the one hand, the stock ownership of board members is positively correlated with better present and future performance of the company as directors receiving stock-based compensation have a greater incentive to supervise and scrutinize decisions in an intense manner (Bhagat, Bolton, and Romano 2008; Bhagat and Bolton 2013). Moreover, compensation by long-term stock options supports the independence of AC members from the management as their interests correspond with those of the investors' (Bhagat et al. 2008) and limits in consequence aggressive earnings management by the managers (Bierstaker, Cohen, DeZoort, and Hermanson 2012). On the other hand, stock-based compensation is associated with a loss of independence in decision making because AC members tend to accept the use of earnings management to maximize their own outcomes (Bédard et al. 2004). One way of guaranteeing objectivity might be to avoid offering stock-based compensation to members of the AC (Magilke, Mayhew, and Pike 2009).

While the disclosure of KAMs generally increases the AC members' financial statement accountability to investors, we assume that there exists an interaction between audit disclosure and stock ownership. More specifically, the effect of the disclosure of KAMs on AC members' behavior might depend on whether or not the AC member owns the company's stocks (Rose, Mazza, Norman, and Rose 2013).

Hence, we assume a different behavior for stock-owning AC members who are not financially independent. Accordingly, we assume that stock-owning AC members are more likely to agree with the management in case of an accounting disagreement between the management and the company's auditor in the event that KAMs are disclosed. Owning the stocks of the company where one serves as a non-executive director might lead to an inner conflict of interest because the financial involvement competes against the critical monitoring duty of the responsible persons. Relating to the theory of moral

licensing, the disclosure of KAMs might serve as a disclaimer and makes them feel morally licensed to act in a selfish manner (Griffin 2014), i.e., agreeing with the management's perceptions and avoiding the auditor's proposed adjustment.

We investigate these hypotheses in a 2-x-2 between-subjects experiment involving 52 incumbent or erstwhile acting non-executive directors. Conducting an experiment serves two purposes: first, it enables one to isolate the investigated factors from other influencing factors, and second, it makes it possible to investigate factors for which no real-world data exists (Kachelmeier and King 2002). In our case, it is not publicly known which issues are discussed by the AC of a company. Additionally, the impacts of the interaction with stock ownership are impossible to find in archival data. Therefore, using an experiment as the research method was the best way to approach our hypotheses.

We find that stock-owning directors are more likely to agree with the management's approach in case the KAMs are disclosed in the auditor's report in contrast with the group without KAMs in the report, in accordance with the theory of moral licensing. However, our results also suggest that non-stock-owning directors are less likely to agree with the management in case KAMs are disclosed in the auditor's report, in accordance with the theories of helping behavior, social responsibility norm and accountability theory.

Our study contributes to recent research in several ways. First, we focus on the implications of AC members' independence under the new KAM regime and investigate the potential interactions between the disclosure of KAMs and independence. Hence, our study contributes to the growing body of KAMs literature. The results of Kang (2019) show an interacting effect of disclosing CAMs and investor sophistication on AC members' behavior. The disclosure of CAMs in the audit report and an unsophisticated investor base lead to an increase in the extent to ask challenging questions (Kang 2019). We extend this existing research, investigating the impacts of KAMs on AC members' behavior by emphasizing on AC members' independence.

Second, our study contributes to the extensive corporate governance literature, especially factors as AC members' corporate governance experience, financial-reporting and audit knowledge, that might influence the decision-making behavior of the AC of a company (Knapp 1987; DeZoort and Salterio 2001; Kang 2019). We focus on AC members' financial independence as further factor to extend existing literature on AC members' decision-making behavior.

Finally, our study might be of interest to standard setters and practitioners. Members of the AC must be aware of an unconscious but possible change in their decision-making process, caused by the disclosure of KAMs in the auditor's report. Standard setters deal with the question of whether disclosure, in fact, achieves the hypothesized positive effects for stakeholders. Furthermore, our results can serve as decision support for standard setters in case the requirement of publishing KAMs in the report is extended to non-PIEs. Additionally, auditors should be aware of the impact of their reporting on board members.

Our paper is organized as follows. Section 2 reviews recent studies on related topics and provides the theoretical background for developing our hypotheses. Section 3 outlines our research method, after which the results are presented in section 4. The last section contains a discussion and our conclusions.

2.3 Theoretical Background and Hypotheses

2.3.1 Recent Research on KAMs

Studies have investigated two possible effects of KAMs. KAMs might affect the informational value and decision usefulness for investors and auditor judgment performance. Additionally, they might affect the quality of financial statements and the audit itself.

Recent research on the informational and communicative value of KAMs for investors yields different results. Sirois et al. (2018) use eye-tracking technology to examine the informational value of KAMs, and their results show that KAMs have attention-directing effects because the participants concentrated on KAM-related disclosures, although only for a limited number of KAMs in the audit report. Christensen et al. (2014) document the decision usefulness of KAMs for investors. They designed an experimental study with business alumni and found that investors are more likely to abandon an investment if a CAM (KAM) paragraph is included in the audit report. Köhler et al. (2020) do not find any communicative value of a KAM section relating to goodwill impairment for non-professional investors, although there was one for professional investors. They distinguish between a negative and a positive KAM section and find that the economic situation of the company is better evaluated in a negative KAMs condition, i.e. if already small changes in the key assumptions could eventually lead to a goodwill impairment. In

contrast, Lennox et al. (2019) do not find any informative value of KAMs for investors using data in the UK.

Studies focusing on aspects of the quality of financial statements and the audit show mixed results. Boolaky and Quick (2016) investigated whether information on KAMs has an impact on the quality of financial statements, the audit and the audit report and credit approval decisions, as perceived by German bank directors. They cannot provide evidence of a positive effect for any of the investigated factors. Bédard, Gonthier-Besacier, and Schatt (2019) examine the effects of justification of assessments (JOA) in France, which are similar to KAMs, on investors (measured by abnormal returns and abnormal trading volume) and the audit (audit quality, costs and efficiency). They find no market reactions or significant effects on aspects of the audit, concluding that JOA do not have the predicted outcomes.

Gold, Heilmann, Pott, and Rematzki (2020) research on whether KAMs affect managers' reporting behavior in case of earnings management activities. Participants who received an audit report with KAMs, including firm-specific content, are less willing to manage earnings compared to those who received a traditional audit report without a KAM section, leading to higher financial reporting quality. Bentley, Lambert, and Wang (2021) investigate whether and how a CAM disclosure affects managers' real operating decisions and find, that a CAMS disclosure decreases managers' risk-decreasing activities more than their risk-increasing activities. Kang (2019) focuses on the effect of investor sophistication and the prospect of CAM disclosure on the AC members' propensity to ask challenging questions about the management's significant accounting estimates. Her findings show that AC members tend to ask more challenging questions in the presence of a more unsophisticated investor base and when there is the prospect of additional CAM disclosures (Kang 2019).

Relating to auditor judgment, Asbahr and Ruhnke (2019) analyze whether reporting an accounting estimate as a KAM can influence auditor judgment and the corresponding action about the accounting estimate and find the existence of a judgment–action gap. Ratzinger-Sakel and Theis (2019) focus on KAMs consideration and client pressure on auditor judgment performance, finding that auditors exhibit significantly less skepticism

in their judgment (as part of auditor judgment performance) in the presence rather than in the absence of KAM consideration.⁵

2.3.2 Development of hypotheses

Being a subcommittee of the supervisory board, the AC has the duty to audit the financial statements of the company for which it serves as a committee on the investors' behalf. In this context, the AC members act in the shareholders' interests, becoming their representatives. This is because on the one hand, investors do not have the legal authority of monitoring the financial reporting and auditing process themselves, and on the other hand, they might not have the cognitive capabilities to do so (Kang 2019).

In order to explain the AC members' psychological motivation to help and protect shareholders, the theories of helping behavior and social responsibility norm serve as theoretical frameworks. Following the theory of social responsibility norm, humans are socialized to help those in need (Schwartz 1975; Baumeister 1982; Eagly and Crowley 1986). Combined with the theory of helping behavior, humans tend to have a higher incentive to help other people if they need help or, rather, are dependent on the help of others (Bornstein 1994; Bekkers and Wiepking 2011; Kang 2019). Transferring these theoretical frameworks on the special situation of an AC and its fiduciary duty to shareholders, the AC is responsible for protecting the shareholders' interests (DeZoort et al. 2002). The shareholders are dependent on the AC's monitoring function and trust in its capability to ensure the reasonability of the financial statements.

However, stock-owning AC members might face an inner conflict of interest because, besides this oversight duty, they have an interest in maximizing the company's profit in order to maximize their personal outcome. In this context, the theory of moral licensing offers a theoretical explanation on how the disclosure of such a conflict can help legitimize a self-serving decision, not acting in the investors' interests. Generally, the theory of moral licensing suggests that disclosure often leads to biased or self-serving decisions, because the decision-maker unconsciously⁶ feels morally licensed to inform the information recipients about the controversial aspect (Cain, Loewenstein, and Moore

⁵ Other researchers focus on the effects of KAMs on judgments of auditor liability (Brasel, Doxey, Grenier, and Reffett 2016; Gimbar, Hansen, and Ozlanski 2016a; Gimbar, Hansen, and Ozlanski 2016b; Vinson, Robertson, and Cockrell 2019; Kachelmeier, Schmidt, Rimkus, and Valentine 2020).

⁶ While moral licensing is an unconscious effect, strategic exaggeration is a similar, but conscious effect (Jamal et al. 2016).

2005; Cain, Loewenstein, and Moore 2011). Moral licensing often occurs in a setting where the information provider or decision maker is facing a conflict of interest. By publicizing this inner conflict, the advisor feels more comfortable making a biased decision as he has forewarned about the situation or his conflict of interest (Griffin 2014). In an accounting setting, Jamal, Marshall, and Tan (2016) conducted an experiment with professional valuers and found that disclosure of a conflict of interest increases bias in the valuers' estimates in cases where their interests coincide with those of the clients'. Prior research has shown the existence of moral licensing in the audit setting as well (Griffin 2014; Ratzinger-Sakel and Theis 2019), assuming that auditors often face a conflict of interest in being paid by their clients while serving the public at the same time (Jamal 2012).

Both Asbahr and Ruhnke (2019) and Ratzinger-Sakel and Theis (2019) interpreted KAMs as a disclaimer with regard to the matters described and confirm that auditors are more willing to act in their clients' interest when KAM consideration is present than when it is absent, due to moral licensing effects. Kachelmeier, Schmidt, Rimkus, and Valentine (2020) also indicate a forewarning effect of CAM disclosures in the auditor's report. Following this perception, KAMs might be seen as disclaimers by the AC, leading them to act in a self-serving manner in case of a conflict of interest. By publishing an accounting issue as a KAM, this conflict is not disclosed itself, but the investing public is informed about the potential accounting inaccuracy or, rather, the risk concerning this issue, providing a reasonable defense for not requiring an accounting adjustment as far as the AC is concerned (Griffin 2014). According to this theory, we assume that stock-owning directors are more likely to agree with the management by supporting an income-increasing financial reporting decision if the controversial issue is published as a KAM in the auditor's report than if it is not published as a KAM.

Therefore, we state the following hypothesis:

H1: Stock-owning AC members tend to agree more with the management's income-increasing financial reporting decisions if the disputed issue is disclosed as KAM than if it is not.

Since non-stock-owning directors do not face this inner conflict of interest, we assume a different psychological pattern and, hence, different behaviors for this group.

Based on the theories of helping behavior and social responsibility norm, we assume that the AC feels accountable to investors due to its function of monitoring and its duty to oversee the financial reporting and auditing process, representing the investors' interests.

Generally, accountability is "the social psychological link between individual decision-makers on the one hand and the social systems to which they belong on the other" (Tetlock 1985). In other words, if decision-makers know about the attitudes and views of the individual(s) they feel accountable to, they adopt these attitudes and act in a manner that reflects that they have the same (Tetlock 1983). However, if the views of the individual(s) to whom they feel accountable are unknown, decision-makers start thinking in a more complex and flexible manner and develop arguments for different positions to defend their final position. In case they have already adopted an attitude, they search for arguments to justify it (Tetlock, Skitka, and Boettger 1989).

According to this theory, we assume that publishing KAMs in the audit report increases directors' accountability toward investors so that directors would try to adopt the decision behavior of the investors. Disclosing KAMs makes the most critical issues of the audit and auditor's responses to these risks transparent to investors. Prior research highlights the fact that investors pay attention to the issues of the financial statements addressed in KAMs (Sirois et al. 2018) and consider these aspects in their investment decisions and evaluation of a company's performance (Christensen et al. 2014; Lennox et al. 2019; Köhler et al. 2020). Hence, KAMs in the auditor's report get more attention from investors, which involves greater accountability of the responsible persons. Based on these findings, we assume that KAMs increase AC members' financial statement accountability toward investors (Kang 2019).

In order to attend to its duty conscientiously, the AC authorizes an external auditor with the task of auditing the financial statements: relating to the principal-agent theory, an auditor is hired by the board of directors as a kind of assistant to monitor the activities and accounting decisions made by management (agent) for the investors (principals) (Schnader, Bédard, and Cannon 2015). Hence, we assume that adopting the auditor's view will be of interest to investors. In contrast, investors might fear that the management could act in a selfish manner to mislead stakeholders or influence contractual outcomes, e.g., to increase personal bonuses based on the company's performance (Healy and Wahlen 1999). Therefore, we assume that the interests of the auditor and investors are

consistent. Auditors presumably have a good reputation as they are an external instance acting independently and prudently. Therefore, in case of a disagreement between the management and the external auditor of a company, we assume that non-stock-owning AC members stand by the external auditor if KAMs are included in the auditor's report.

Summarizing this predicted effect, we state the following hypothesis:

H2: Non-stock-owning AC members tend to agree less with the management's income-increasing financial reporting decisions if the disputed issue is disclosed as a KAM than if it is not.

2.4 Research Design⁷

2.4.1 Administration

In order to increase the participation in our experiment, we created a web-based case study with the online survey software Unipark. The study was distributed in two different ways:

i) the link to the survey was published in the cover letter to the Audit Committee Quarterly III/2018 by the German KPMG Audit Committee Institute; and ii) an invitation to participate was sent by e-mail to potential participants, belonging to PIEs. By using an electronic version instead of a handwritten survey, we were able to ensure that each question was answered, if specific answers were possible (e.g., age), and participants were not allowed to return to prior pages, except where explicitly intended. Each IP address was only allowed to participate once.

2.4.2 Experiment Task and Materials

To ensure empirical realism and perspicuity in the case materials, we discussed the case with a highly experienced AC member and an audit partner of a big 4 company. Furthermore, it was pretested by three auditing researchers and a few auditing and accounting students. The pretest resulted in a few minor amendments.

The experimental materials were administered in German. The materials consisted of a general introduction, introducing ourselves and assuring the participants of anonymity and confidentiality. To ensure that participants really belonged to our target group of non-

⁷ Approval has been granted by the institution at which the experiment took place.

executive directors, we asked whether they are or were a member of the supervisory board, before the case materials were presented. If they replied in the negative, they were directly screened out.⁸

The case began with a short introduction explaining to the participants that they should assume they were a member of the AC of a fictitious company. After that all participants got a short description of the company⁹ and were randomly assigned to one of four groups. First, they either got the information that they should assume to be in possession of a material amount of stocks of the fictitious company in their private portfolio or not (Manipulation 1). On the next page, the case study was described: A disagreement occurred between management and the external auditor concerning a goodwill amortization of a cash generating unit. The auditor appealed for an adjustment, whereas management was against this adjustment. In this context it is explained, that the disputed amount is immaterial and that any resolution of the issue will not impact the content or form of the audit report. Otherwise, if the disputed amount was above materiality, the participants would have no real choice to make their decision without imperiling the auditor's unqualified audit opinion (Rose et al. 2013). The consequences of not accepting the adjustment are presented: Internally, the issue is added to the summary of uncorrected audit misstatements as attachment to the internal audit report¹⁰; externally, the result of the annual audit is communicated as independent auditor's report. On the next page, the second treatment occurs: Participants were presented randomly with one of two potential audit reports of the current year. It was either a standard audit report, i.e., without a KAM section¹¹, or an ISA 700 audit report with a related key audit matter (goodwill) with reference to the previous described case was provided (Manipulation 2). The participants were then asked to take a position using a 10-point Likert scale. On a voluntary basis, it was possible to add reasons for the opinion in a free text field. Following the experimental

⁸ To become a subscriber of the Audit Committee Quarterly, one has to be part of a supervisory board or management. Furthermore, we only used personalized e-mail addresses. The screening out-condition was one more security to ensure participants have board member experience.

⁹ For simplicity, numerical financial information as balance sheet and income statement are not included in the description.

¹⁰ In Germany, a much more detailed audit report has to be generated to management and supervisory board, according to Paragraph 321 German Commercial Code. It is important to differentiate between the independent auditor's report, that is publicly available and the internal audit report, that is only available for the company's legal representatives.

¹¹ A standard audit report without a KAM section is a shorter version of the audit report before ISA 701 was established.

part, the participants answered some manipulation checks, psychological questions and demographic items.

2.4.3 Variables

The independent and manipulated variables are stock-ownership (yes/no) and KAMs section in the audit report (present/absent). Therefore, we conducted a 2-x-2 between-participant experiment. We investigated the effect of these factors on the decision behavior of directors concerning an income increasing issue and consequently on financial reporting quality. In order to measure this effect, participants were asked whether they vote for or against the adjustment on a 10-point Likert scale (1 = I vote for the adjustment; 10 = I vote against the adjustment), representing our dependent variable.¹²

2.4.4 Participants and Manipulation Checks

In this research, incumbent or erstwhile non-executive directors of German companies participated. We mailed our task materials and the questionnaire to 988 supervisory board members. The first reminder was sent 54 days later, the second one after 113 days of the first reminder. The e-mail request resulted in 56 responses, constituting a participation rate of 5.7%.¹³ Additionally, 125 persons reacted to the provided URL in the Audit Committee Quarterly, wherefrom 11 participants could be recruited, representing a participation rate of 8.8%.¹⁴ Thus, the final sample consisted of 67 responses.

To check whether the manipulation of the independent variables was successful and that the case material was understood correctly, we included two manipulation check questions: We first requested if the case asked to assume that the participants are in possession of a material amount of stocks and second, if the presented audit report included KAMs, both responses being on a Likert scale with endpoints 1 (“strongly disagree”) to 7 (“strongly agree”). 15 participants failed to answer at least one of these

¹² Surveys with auditors show, that about half of the respondents indicated they are involved in resolving contentious issues (52%) (Cohen, Krishnamoorthy, and Wright (2010)); one-third of audit partners indicated that they discuss significant disagreements they had with management (Cohen, Krishnamoorthy, and Wright (2002). Therefore, consistent with Rose et al. (2013), we chose the dependent variable as the likelihood of siding with management or the external auditor in case of a disagreement between these two parties to measure the participants' attitude concerning this accounting issue.

¹³ 11 participants were screened out due to missing experience as a non-executive director. Moreover, we received 47 responses from participants who explained why they were not willing to participate. Thus, the response rate is 11.5 % and therefore much higher than the participation rate.

¹⁴ Actually, 14 persons participated, but three participants were screened out due to missing experience as a non-executive director and therefore are not counted as participants.

questions correctly and their responses were consequently excluded from the ensuing analysis¹⁵, resulting in 52 usable answers.

Further, we asked some attention check questions concerning the public availability of the auditor's report and the summary of uncorrected audit misstatements as attachment to the internal auditor's report, as well as if the described issue could result in a qualified audit opinion due to its materiality. All statements were to be assessed on a 7-point Likert scale with endpoints 1 ("strongly disagree") to 7 ("strongly agree"). Overall, these questions were answered mostly correctly with a mean of $\mu = 6.3$ saying the auditor's report is publicly available, $\mu = 2.5$ proving the summary of uncorrected audit misstatements is not publicly available and $\mu = 3.0$ affirming the discussed issue is not material. The answers to these questions confirmed the expertise of the participants and correct understanding of the presented information.¹⁶

To test for non-response bias in the group contacted by e-mail, we compared early and late responses, assuming that late responses serve as an indicator of non-response (Wallace and Mellor 1988; Quick and Schmidt 2018). The test shows no significant differences between the two groups, and thus a non-response bias does not exist.

Moreover, we checked for differences in responses between the two ways of contacting participants (e-mail vs. URL). These test results do not show a significant difference between the two groups, either (Asbahr and Ruhnke 2019).

Table 2.1 provides demographic information for participants. The average age was 52 years (*AGE*) and the participants were mostly men, with 36 male (72.0 %) and 14 female (28.0 %) participants (*GENDER*). On average, the participants have practical experience as non-executive directors of 7 years (*EXP*), whereof 31 participants (67.4 %) are part of an AC. Most are members of the supervisory board in a MDAX-Company or an SME. 29 participants are representatives of shareholders and 21 are representatives of employees (*REP*). Nine participants have working experience in auditing for an average of at least five years, most of them in a high position as manager or partner.

¹⁵ The failure rate on the manipulation check questions is comparable to other studies (e.g. Quick and Schmidt 2018; Ratzinger-Sakel and Theis 2018).

¹⁶ We repeated our analysis, including only participants who answered all manipulation and attention check questions correctly. The results of the ANOVA (statistical significance of the interaction term) remain the same, which is why we include participants who missed the attention check questions.

Table 2.1: Demographic items

Variable	Obs	Mean	Std. Dev.	Min	Max
GENDER	50	1.72	0.45	1	2
AGE	48	51.69	7.78	28	62
EXP	49	7.02	5.70	1	21
NR_AC	46	1.48	2.02	0	9
DAX	50	0.24	0.43	0	1
MDAX	50	0.36	0.48	0	1
SDAX	50	0.16	0.37	0	1
TecDAX	50	0.06	0.24	0	1
BIG COMP	50	0.30	0.46	0	1
SME	50	0.36	0.48	0	1
REP	50	1.58	0.50	1	2
AUD_EXP	49	1.82	0.39	1	2

Explanation of variables:
GENDER: Female = 1 / Male = 2; *AGE*: Age of participant; *EXP*: Number of years the participant is part of a supervisory board; *NR_AC*: 1 = Number of memberships in an audit committee; *DAX*: Membership in a supervisory board of a DAX-company = 1, 0 otherwise; *MDAX*: Membership in a supervisory board of a MDAX-company = 1, 0 otherwise; *SDAX*: Membership in a supervisory board of a SDAX-company = 1; 0 otherwise; *TecDAX*: Membership in a supervisory board of a TecDAX-company = 1, 0 otherwise; *BIG COMP*: Membership in a supervisory board of a non-listed, big company = 1, 0 otherwise; *SME*: Membership in a supervisory board of a small and medium-sized enterprise = 1, 0 otherwise; *REP*: Representative of employees, yes = 1 / no = 2; *AUD_EXP*: Practical experience in an audit company, yes = 1 / no = 2

2.5 Results

2.5.1 Test Results

Table 2.2, panel A shows descriptive statistics as means, standard deviations and sample sizes across the treatment conditions. The results of the ANOVA are presented in Table 2.2, panel B¹⁷. As predicted, the interaction term of KAMs and stock ownership is statistically significant ($p = 0.009$ one-tailed), whereas these effects are individually not statistically significant (KAMs: $p = 0.319$ one-tailed and stock ownership: $p = 0.235$ one-tailed).¹⁸ The corresponding interaction pattern is shown in Figure 2.1.

¹⁷ We ran ANCOVA models, where we included demographic items as covariates. None of the demographic variables correlated with our dependent variable and therefore none was added to our model as covariate.

¹⁸ Using the full sample, including the manipulation check failures (67 answers), leads to the following results: Model: $p = 0.104$; KAMs: $p = 0.247$; stock ownership: $p = 0.083$; interaction term: $p = 0.045$, all one-tailed. There exist significant differences between the groups of non-stock-owning directors with and without KAMs ($p < 0.1$ one-tailed) and the group with KAMs and stock ownership and the group with KAMs, but without stock ownership ($p < 0.05$ one-tailed). All other differences remain insignificant.

Table 2.2: Results

Panel A: Mean (standard deviation) {sample size}		
Stock Ownership	KAMs Disclosure	
	Present	Absent
Yes	5.00 (3.67) {17}	2.55 (2.16) {11}
No	2.33 (2.27) {12}	4.00 (3.02) {12}

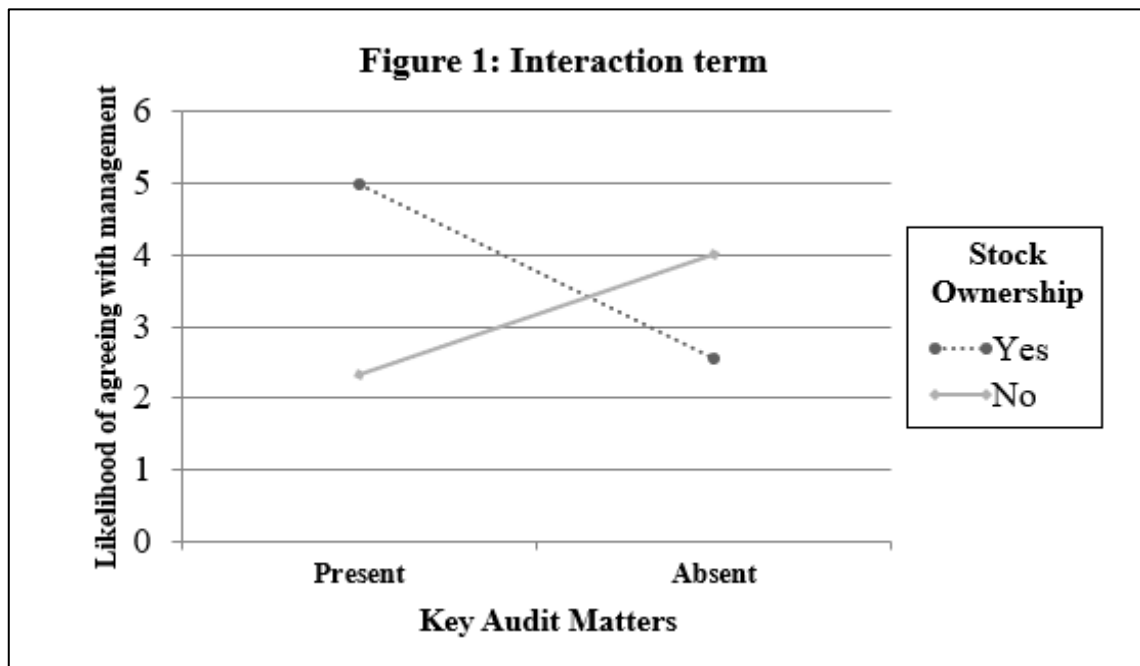
Panel B: ANOVA results					
Source	Partial SS	df	Mean Square	F-value	p-value
Model	66.66	3	22.22	2.54	0.034**
Key Audit Matters (KAMs)	1.96	1	1.96	0.22	0.319
Stock Ownership (SO)	4.64	1	4.64	0.53	0.235
KAMs x SO	53.68	1	53.68	6.14	0.009***
Error	419.39	48	8.74		
Total	486.06	51	9.53		

Significant at 0.05 level (one-tailed); *Significant at 0.01 level (one-tailed)

Panel C: Post-hoc mean comparisons (Least Significant Difference)				
			S. E.	p-value
KAMs / Stocks	vs.	No KAMs / Stocks	1.14	0.019**
KAMs / Stocks	vs.	KAMs / No Stocks	1.11	0.011**
KAMs / No Stocks	vs.	No KAMs / No Stocks	1.21	0.087*
No KAMs / Stocks	vs.	No KAMs / No Stocks	1.23	0.122

*Significant at 0.1 level (one-tailed); **Significant at 0.05 level (one-tailed)

Figure 2.1: Interaction Term



We conducted post-hoc mean comparisons to determine differences between the individual groups (Table 2.2, Panel C). The test results show that stock-owning directors are more likely to agree with management's position concerning an income increasing accounting issue, if this issue is disclosed as a KAM in the auditor's report ($\mu = 5.00$), compared to a standard audit report without KAMs ($\mu = 2.55$). The results also show a significant difference between these groups ($t = -2.15$, $p = 0.019$ one-tailed), hence, H1 is supported. This result is in accord with the theory of moral licensing, showing that stock-owning directors are facing an inner conflict of interest due to their personal financial situation, where the KAMs serve as a disclaimer so they can make a self-serving decision with a clear conscience.

The corresponding group of non-stock-owning executive directors is less likely to adopt management's income increasing financial reporting decisions in case a disputed issue is published as KAM ($\mu = 2.33$), compared to a standard audit report without KAMs ($\mu = 4.00$). Hence, H2 is supported ($t = 1.38$, $p = 0.087$ one-tailed).

We also find a significant difference between the decision of stock-owning members of the AC compared to non-stock-owning members of the AC, in case of an audit report including KAMs ($t = -2.39$, $p = 0.011$ one-tailed). The results show that stock-owning directors agree more with management ($\mu = 5.00$) than non-stock-owning directors ($\mu =$

2.33). This result again supports the moral licensing theory, because stock-owning directors are more willing to refuse the adjustment proposed by the auditor despite facing a conflict of interest, their stand being legitimated by disclosure of the discussed issue.

The answers in the (optional) free text field support our findings: Stock-owning directors without a KAMs section more often mention a conflict of interest due to their stock ownership, compared to stock-owning directors with a KAMs section in the auditor's report. This group also relies on the predominant -in Germany- principle of prudence. Other arguments are the expertise of management or the auditor, materiality or the hint to discuss the issue until a mutual solution is found.

2.5.2 Post-experiment debriefing items

In order to find out about the reasons for the directors' decisions, we asked some further questions. First, we asked which part of the independent auditor's report was of particular interest to the participants. In the No-KAMs-condition, 14 of 21 participants (60.9 %) indicate they are most interested in the opinion of the auditor, whereas in the KAMs-condition, 14 of 28 participants (50.0 %) indicate KAMs were of particular interest to them, and 8 of 28 participants (28.6 %) were mostly interested in the opinion. This result illustrates the relevance of KAMs for practitioners, showing that most participants are more interested in KAMs than in the opinion itself.¹⁹

We also asked which of the following factors influenced the decision making, on a 5-point Likert scale with endpoints 1 ("strongly agree") to 5 ("strongly disagree"): agreement with the external auditor or management, avoidance of further inquiries by shareholders, personal investment portfolio or materiality of the issue. We find a significant difference ($p = 0.012$) between non-stock-owning directors and stock-owning directors concerning the influence of the personal investment portfolio, showing that stock-owning directors are more influenced by their investment portfolio ($\mu = 4.1$) than non-stock-owning directors ($\mu = 5.0$), supporting our main results. Moreover, we find a significant difference ($p = 0.009$) between the two groups of stock-owning directors. Stock-owning directors in the KAMs-condition incline relatively more towards the fact that the presented issue was not material ($\mu = 1.3$) than their corresponding group in the

¹⁹ In the KAM-Condition, it is possible the high percentage indicating KAMs being of high importance results from a demand effect, because the participants might be aware KAMs are the focus of the experiment.

No-KAMs-condition ($\mu = 2.2$). This result discloses the argumentation of stock-owning directors in the KAMs-condition, who use the aspect of materiality as an argument in order to make a more self-serving decision.

Additionally, we asked participants to evaluate further statements on a 5-point Likert scale with endpoints 1 (“strongly agree”) to 5 (“strongly disagree”), to extract some background information:

(1) *The audit committee, generally the supervisory board of a company, is responsible for informing the public about potential risks.*

(2) *The disclosure of key audit matters in the independent auditor's report spotlights the supervisory board's work to the public.*

The overall reactions to statement two ($\mu = 2.0$ - “agree”) support the relevance of KAMs and especially their influence on the AC, thereby contributing to our research topic. While we do not find significant differences between the groups' evaluation of the first statement, we find a significant difference between stock-owning directors with and without a KAMs section concerning the second statement ($p = 0.008$), indicating that participants in the KAMs-condition are more likely to agree with this statement ($\mu = 1.6$) than participants in the No-KAMs-condition ($\mu = 2.7$).²⁰ Directors, who are affected in practice and not just in theory by KAMs, are aware of their meaning and potential consequences for the supervisory board.

2.6 Conclusion

Key audit matters (KAMs) in the auditor's report were introduced by the standard setters in order to improve the quality of auditors' reporting by increasing its informational value for investors and other addressees. Recent research has focused on the potential effects of KAMs on both professional and non-professional investors, auditors and managers. We extend this research area by focusing on the impact KAMs have on the decision behavior of ACs.

We conducted an experiment with members of the supervisory board, in which context the participants should assume a difference of opinion between the external auditor and

²⁰ To guarantee the same level of knowledge about KAMs in the group without KAMs in the presented auditor's report, we added a short definition of KAM at this point.

management in case of an accounting issue. We manipulated the auditor's report (KAMs present vs. KAMs absent) and stock ownership of a fictitious company (yes vs. no), assuming there exists interdependency between KAMs and stock ownership.

Our results show that stock-owning directors are more likely to agree with management's approach in case KAMs are included in the auditor's report, compared to the group without KAMs in the report. This result is based upon the moral licensing theory, which says that publishing a conflict of interest appears as a disclaimer and legitimates a self-serving decision through having informed about this conflict. In our case, KAMs do not publish the conflict itself, but inform stakeholders about a potential inaccuracy and higher risk of an accounting issue and therefore legitimate a decision that improves the annual result.

In contrast, our results show that non-stock-owning directors are less likely to agree with management in case KAMs are included in the auditor's report, due to accountability theory. Basically, financially independent directors are more likely aligned with the interests of financial statements users based upon the theories of helping behavior and social responsibility norm. In case KAMs are disclosed in the audit report, their sense of duty to review the disclosed issues is even stronger, because they are aware investors rely on this information and feel more accountable to ensure reliability and reasonability of these aspects (Kang 2019).

Our study is not without limitations. First, the explanatory power of our results is limited due to the small sample size. Therefore, statistical validity of our results might be weak. On the one hand, the results are more realistic considering the use of incumbent supervisory board members, while on the other hand, it is difficult to acquire such a group of high-level participants. Second, we isolated the effects of KAMs and stock ownership on the decision behavior of the AC, but ignored other aspects that might influence directors' decision making, like personal characteristics, which are hard to measure. Third, it is not possible through a fictitious case to simulate realistic conditions that are much more complex than experimental cases.

Alternatively, archival data could be used to simulate realistic conditions. Another line for future research is to combine stock ownership with other aspects of corporate governance, for example relationship to management or strength of internal auditing.

Our results are of particular interest to standard setters and practitioners who deal with KAMs in practice. It is important to consider that disclosure efforts do not necessarily improve financial reporting quality, but are considered in the decision-making process of responsible persons and are influenced by other factors such as independence, or rather stock ownership.

2.7 Appendix

EXHIBIT A: Manipulation of stock ownership

1) Stock ownership

You currently own Food AG shares and your share ownership is significant to your personal investment portfolio.

2) Non-Stock ownership

You do not currently own shares of Food AG in your personal investment portfolio.

EXHIBIT B: Manipulation of independent auditor's report

Consequences:

- Internally, in case of not adjusting the impairment amount, the issue would be added to the **summary of uncorrected audit misstatements**, which is an attachment of the **internal** audit report and has to be registered and signed by management.
- Externally, the result of the annual audit is communicated as **independent auditor's report**. In the following, you receive the external report of the auditor.

1) Auditor's report including KAMs

Independent auditor's report

To Food AG

Audit Opinion on the Consolidated Financial Statements

We have audited the consolidated financial statements of Food AG, Düsseldorf, and its subsidiary (the Group), which comprise the consolidated statement of financial position as at December 31, 2017, and the consolidated income statement, the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the financial year from January 31, 2017, to December 31, 2017, and notes to the consolidated financial statements, including a summary of significant accounting policies.

According to § (Article) 322 Abs. (paragraph) 3 Satz (sentence) 1 zweiter Halbsatz (second half sentence) HGB ("Handelsgesetzbuch": German Commercial Code), we state that, in our opinion, based on the findings of our audit, the accompanying consolidated financial statements comply, in all material aspects, with IFRS, as adopted by the EU, and the additional German legal requirements applicable under § 315a Abs. 1 HGB and give a true and fair view of the net assets and financial position of the Group as at December 31, 2017, as well as the results of operations for the financial year from January 31, 2017, to December 31, 2017, in accordance with these requirements.

Basis for Audit Opinion on the Consolidated Financial Statements

We conducted our audit in accordance with Sec. 317 HGB and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer (Institute of Public Auditors in Germany; IDW). We conducted the audit of the consolidated financial statements in supplementary compliance with International Standards on Auditing (ISA).

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements for the financial year from January 31, 2017, to December 31, 2017. These matters were addressed in the

context of our audit of the consolidated financial statements as a whole, and in forming our audit opinion thereon; we do not provide a separate audit opinion on these matters.

1 Recoverability of the carrying amount of goodwill

The risk - In the consolidated financial statements of Food AG as of December 31, 2017, goodwill of EUR 12 million is reported. In performing the impairment test for goodwill, which is conducted annually, the carrying amounts of the respective cash-generating units are compared with their respective recoverable amounts. The recoverable amount is determined at Food AG based on fair value less costs to sell. For this purpose, fair value is determined using a discounted cash flow model. Future cash flows are discounted using the weighted average cost of capital of the respective cash-generating unit. This measurement is highly dependent on estimates of future cash flows as well as on the cost of capital used and therefore subject to considerable uncertainty.

Our reaction

- Evaluation of the methodical approach
- Verification of calculation procedures
- Assessment of the appropriateness of assumptions like future cash flows, perpetuity growth rates and discount rates
- Comparison with the current budget for the years 2018-2020 drawn up by Management and approved by the Supervisory Board

2) Provisions

The risk – Food AG is involved in legal and out-of-court proceedings with public authorities, competitors, and other parties. These give rise to legal risks, in particular in the areas of product liability, tax law, and environmental protection.

Whether a pending legal dispute makes the recognition of a provision to cover the risk necessary and, if so, to what extent, is determined to a large extent by estimates and assumptions by Management.

Especially a product-related dispute concerning the product “Fly High” was of particular significance from our point of view, because it represents a material amount of other provisions (5 Mio. EUR).

Our reaction

- Assessment of the process established to ensure the recognition, the estimate of the outcome of the proceedings, and the accounting presentation of a legal dispute.
- Discussions with the Company's internal legal and tax department
- Making available the development of material legal disputes, including the estimates by Management with regard to the possible outcome of proceedings in writing
- Obtaining external attorney's certificates and discussions with external experts in case of material legal disputes

[...]

Düsseldorf, February 19 2018
MIHO AG
Wirtschaftsprüfungsgesellschaft

2) Standard audit report (without KAMs)

Independent auditor's report

To Food AG

Audit Opinion on the Consolidated Financial Statements

We have audited the consolidated financial statements of Food AG, Düsseldorf, and its subsidiary (the Group), which comprise the consolidated statement of financial position as at December 31, 2017, and the consolidated income statement, the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the financial year from January 31, 2017, to December 31, 2017, and notes to the consolidated financial statements, including a summary of significant accounting policies.

According to § (Article) 322 Abs. (paragraph) 3 Satz (sentence) 1 zweiter Halbsatz (second half sentence) HGB (“Handelsgesetzbuch”: German Commercial Code), we state that, in our opinion, based on the findings of our audit, the accompanying consolidated financial statements comply, in all material aspects, with IFRS, as adopted by the EU, and the additional German legal requirements applicable under § 315a Abs. 1 HGB and give a true and fair view of the net assets and financial position of the Group as at December 31, 2017, as well as the results of operations for the financial year from January 31, 2017, to December 31, 2017, in accordance with these requirements.

Basis for Audit Opinion on the Consolidated Financial Statements

We conducted our audit in accordance with Sec. 317 HGB and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer (Institute of Public Auditors in Germany; IDW). We conducted the audit of the consolidated financial statements in supplementary compliance with International Standards on Auditing (ISA).

[...]

Düsseldorf, February 19 2018
MIHO AG
Wirtschaftsprüfungsgesellschaft

3. Key Audit Matters: Qualitätssteigerung für den Bericht des Aufsichtsrats? – Eine empirische Analyse der Aufsichtsratsberichte der DAX-, MDAX- und SDAX-Unternehmen 2017 –

3.1 Publikationsdetails

Höfmann, M./ Heilmann, M./ Pott, C. (2019). Key Audit Matters: Qualitätssteigerung für den Bericht des Aufsichtsrats? – Eine empirische Analyse der Aufsichtsratsberichte der DAX-, MDAX- und SDAX-Unternehmen 2017 –.

KoR – Zeitschrift für internationale und kapitalmarktorientierte Rechnungslegung, 9, 386-393.

4. Informationsmehrwert oder Standardbericht? – Die Entwicklung der KAM-Berichterstattung in Deutschland –

4.1 Publikationsdetails

Forstmann, L./ Heilmann, M./ Höfmann, M. (2020). Informationsmehrwert oder Standardbericht? – Die Entwicklung der KAM-Berichterstattung in Deutschland –.

Der Betrieb, 47, 2477-2482.

5. The impact of audit report expansions and audit committee strength on bank directors' perceptions and decisions: An experimental investigation

5.1 Publication Details

Abstract: This study investigates the impact of different audit report expansions—a going concern emphasis-of-matter paragraph (GC-EOM), information on the management and auditor's responsibilities, and the characteristics of the audit committee—on the bank directors' perceptions and decisions. In a $2 \times 2 \times 2$ between-subjects experimental design with 85 German bank directors, we observe that a GC-EOM in the auditor's report leads to more unfavorable decisions, based upon a source credibility effect. Contrarily, explanations on responsibilities and different characteristics of the audit committee do not significantly impact bank directors' perceptions and decisions. We thus confirm the effectiveness of the International Auditing and Assurance Standards Board (IAASB)'s revision of the International Standard on Auditing (ISA) 570 to enhance the informational value and decision usefulness of the auditor's report.

Co-Authors: Prof. Dr. Christiane Pott, Prof. Dr. Reiner Quick

Keywords: Auditor's Report, Going Concern, Emphasis-of-Matter Paragraph, Bank Directors

Publication Status: Under review at the *International Journal of Auditing*.

5.2 Introduction

Factors increasing the decision usefulness of financial statements are still a focal point of research in this field. An important factor is the audit of statements by an independent auditor who produces an audit report that has long been criticized by investors for its poor information value. To increase the value of such reports and reduce the audit expectation gap, some material changes have been implemented in the last decade. A stream of research focuses specifically on the going concern uncertainty notes in the audit reports, i.e., reports on the audit of financial statements of companies containing a short note related to going concern, because there exist doubts to continue as a going concern due to significant events or conditions. In such cases, the auditor must add a separate paragraph to the audit report, under the heading “Material Uncertainty Related to Going Concern” to highlight this uncertainty to the financial statement addressees, while expressing an unmodified audit opinion.²¹ This paragraph refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor’s judgment, is of such importance that it is fundamental to the users’ understanding of the financial statements (IAASB 2015d, Para. 7[a]). The requirement to add this GC-EOM paragraph to the auditor’s report was implemented in 2015 by the ISA 570 (revised) “going concern,” which was transformed into German standards by The Institut der Wirtschaftsprüfer in Deutschland e.V. [Institute of Public Auditors in Germany, Incorporated Association] (IDW) Auditing Standard 270 (revised) in 2018.

While one vein of research investigates the market reactions following the disclosure of a going concern uncertainty (GCU) note, another one focuses on the impact of the way in which such a note is disclosed (Bédard, Brousseau, and Vanstraelen 2019). Usually, the market only reacts to “new” information. Therefore, it is debatable whether a GC-EOM in the auditor’s report is informative at all because it is merely a repetition of the information concerning the GCU, which is also provided in the notes of financial statements (Carson et al. 2013; Mock et al. 2013). However, Anandarajan, Viger, and Curatola (2002) and Bédard, Brousseau, and Vanstraelen (2019) show that a GC-EOM in the auditor’s report can provide an incremental value to investors under specific circumstances, even though it might not contain additional information. However, before

²¹ This approach is applicable if the disclosure of the material uncertainty is made adequately in the financial statements by management.

the current version of the GC-EOM was implemented, only a short note instead of an entire section concerning the GCU was added to the auditor's report. As such, the information value concerning a firm's GCU disclosed in the audit report might have changed. Related to this, we investigate the added value of a GC-EOM for investors and creditors in Germany.

Another extension of the auditor's report is the mandatory inclusion of a description of the responsibilities of each party to prepare and audit the financial statements to reduce the audit expectation gap, implemented by the revision of the ISA 700. The audit expectation gap is defined as the gap between the auditors' and financial statement users' perceptions pertaining to the annual audit of a company's financial statements (IAASB 2011). While financial statement addressees often expect the absolute assurance that the financial statements are free from material misstatements, auditors merely guarantee reasonable assurance (Epstein and Geiger 1994). Furthermore, financial statement users attribute the responsibility for the adequacy of the financial statements to the auditors, although, in fact, it is the management's responsibility (Anderson, Maletta, and Wright 1998). By adding descriptions of each party's responsibilities in the preparation and audit of the financial statements, this ambiguity can be clarified.

As prior scandals have shown, the corporate governance systems are also still in need of improvement. Related to this, worldwide regulatory changes followed including the requirement to implement an audit committee as part of firms' monitoring system. Currently, the draft of the new German law to strengthen the integrity of the financial market (*Finanzmarktintegritätsstärkungsgesetz*—FISG) explicitly addresses changes that shall strengthen the corporate governance, e.g., it plans to increase the requirements on the professional qualifications of the audit committee members. The audit committee is an important element of corporate governance, as it is a monitoring authority regarding the financial reporting process (Agoglia, Douppnik, and Tsakumis 2011). Therefore, the strength of a company's audit committee regarding its financial expertise, independence, and activity level also potentially influences the shareholders' reactions and decisions, as a strong corporate governance strengthens the confidence in the financial statements. For instance, less earnings management is pursued in the presence of an audit committee whose members are independent and possess financial expertise (Xie, Davidson III, and DaDalt 2003; Bédard, Chtourou, and Courteau 2004; Ben Amar 2014), which ultimately leads to positive market reactions (DeFond, Hann, and Hu 2005).

In this paper, we experimentally investigate whether expansions of the auditor's report and different characteristics of the audit committee affect bank directors' perceptions and decision making in Germany, using a $2 \times 2 \times 2$ between-subjects design with 85 German bank directors. Bank directors are typically highly knowledgeable people representing creditors, investors, and financial intermediaries at the same time. Moreover, banks are an important part of corporate governance in Germany (Booak and Quick 2016; Quick and Inwinkl 2020).

More specifically, we examine potential impacts of both a GC-EOM and explanations regarding the responsibilities of a company's management and supervisory board as well as the auditor's responsibilities on the bank directors' perceptions and decisions. Concerning corporate governance, we manipulate the strength of the audit committee with regard to financial expertise, independence, and frequency of meetings (Agoglia, Doupnik, and Tsakumis 2011).

We ask concretely for their decisions in granting loans, making personal investments, or recommending share purchases to customers. Furthermore, we ask for the perceived reliability of the financial statements, the ability to continue as a going concern, and the economic situation of the company.

Overall, our findings suggest that additionally disclosing a GCU in the auditor's report in the form of a GC-EOM leads to more unfavorable decisions by bank directors. Due to a source credibility effect—interpreting the audit report as a source more credible than reports stemming from management, bank directors recommend and invest less and grant loans with a decreased probability if a GC-EOM is included in the auditor's report. In contrast, we do not find significant impacts of the disclosure of a responsibilities paragraph in the auditor's report or the strength of the audit committee on bank directors' perceptions and decisions.

To the best of our knowledge, this is the first study that focuses on the impacts of different audit report expansions and audit committee strength on bank directors' perceptions and decisions in Germany.²² We empirically measure the added value of the ISA 570 (revised) and ISA 700 (revised) and corresponding standards in Germany (revised IDW Auditing

²² A comparable study investigating loan officers' perceptions across alternative going concern reporting formats in Canada was published by Anandarajan et al. 2002.

Standards 270 and 400) with regard to the reporting of a GCU and responsibility of the auditor and management.

Our study contributes to recent research in several ways: first, while prior research mainly investigated whether a GCU note in the audit report had incremental value on the management's notes to the financial statements, the current study focuses on GC-EOM as obligated by ISA 570 (revised). Second, prior studies were mainly performed in the Anglo-American setting (Anandarajan, Viger, and Curatola 2002; Bédard, Brousseau, and Vanstraelen 2019), while the informational value of such a paragraph in Continental Europe is mostly unexplored (Bédard, Coram, Espahbodi, and Mock 2016). We answer this open question by using German bank directors as participants and thereby investigate whether the revision of ISA 570 adds an additional value. Third, while prior literature investigated whether responsibility explanations reduced the audit expectation gap (Gold, Gronewold, and Pott 2012), we focus on its impact on financial statement addressees' perceptions and decisions. Fourth, we contribute to the corporate governance literature, investigating the effect of different audit committee characteristics with regard to financial expertise, independence, and the frequency of meetings on bank directors' perceptions and decisions. While prior research focusing on the audit committee was mainly performed in the Anglo-American setting, we contribute to the research gap existing for audit committees acting in two-tier systems. Lastly, we use bank directors as subjects as they are of particular relevance as creditors, investors, and financial intermediaries (Quick and Inwinkl 2020). The findings of this study should be of interest to both standard setters—particularly the IAASB—because we empirically evaluate the potential added value of the ISA 570 (revised) and researchers focusing on aspects of corporate governance and auditing by extending and contributing to this research area. Moreover, the results should be interesting for practitioners, more specifically auditors and financial statement readers, being the addressees of the auditor's report.

The remainder of the paper is organized as follows. The next section provides some background information, an overview of the prior research, and develops the hypotheses. Section 3 describes the experimental design and the subjects participating in the study, followed by the research results in Section 4. The final section summarizes the main findings, discusses their implications and the study's limitations, and identifies areas for future research.

5.3 Background, prior research, and development of hypotheses

Going concern emphasis-of-matter paragraph

The IAASB additionally revised its ISA 570 with regard to going concerns. For audits of financial statements for the periods ending on or after December 15, 2016, this revised standard also implies new regulations for the auditor's report: while the auditor had to add a short note on going concerns in case of the adequate disclosure of a material uncertainty in the financial statements so far, "the auditor's report shall [now] include a separate section under the heading 'Material Uncertainty Related to Going Concern'" (IAASB 2015a). In Germany, the new requirements of the ISA 570 were transformed into German standards by the IDW Auditing Standard 270 (revised), which came into force for audits of financial statements for periods beginning on or after December 15, 2017.

Many archival studies examined market reactions to audit reports in the pre-EOM period where the audit report contained a short note related to going concerns. In their research synthesis concerning audit reporting for GCU, Carson et al. (2013)²³ cite several studies that found large negative abnormal returns in the weeks preceding the issuance of the audit report containing a going concern uncertainty note but no response to the issuance of the note itself, as the audit report reflects what is also disclosed in the financial statements, hence, it does not provide additional information to investors. Another research synthesis by Mock et al. (2013), focusing on the audit reporting model, also supports the results of the studies presented by Carson et al. (2013), implying that, when the financial statements include a going concern uncertainty disclosure (GC-FS), the market does not react to the GCU note in the audit report because it does not provide any additional information. In contrast, Menon and Williams (2010) observe negative excess returns when a note concerning GCU is added to the auditor's report for the first time. The reaction is even more negative if the going concern note contains new information to investors (e.g., a specific problem with financing).

Bédard, Coram, Espahbodi, and Mock (2016) review further studies investigating the impacts of a GCU note in the audit report. In most of the reviewed studies, a significant association between the GCU note and measures of usefulness (e.g., informativeness of

²³ Geiger, Gold, and Wallage (2019) continue with the synthesis by Carson et al. (2013) by reviewing and synthesizing 149 academic studies authored since 2013.

earnings) was found. Geiger and Kumas (2018) assessed the trading reactions of institutional investors to a first-time GCU note once it is announced, finding evidence that investors increase their net selling after a firm receives a severe first-time GCU note.

In their experimental study with non-academic members of the Australasian Institute of Banking and Finance (AIBF), Bessell, Anandarajan, and Umar (2003) find that a GC-EOM does not provide incremental information, because it does not convey additional information once the information is already disclosed as GC-FS.

In contrast, Anandarajan, Viger, and Curatola (2002), in their experimental study with Canadian bank loan officers, present that a GC-EOM has a significant influence on their reactions to and perceptions of risk. Supporting these findings, Bédard, Brousseau, and Vanstraelen (2019) examine the impact of a GC-EOM over GC-FS on investors' reactions in a "natural experiment" provided by a change in Canadian auditing standards. In case of a GC-EOM, findings indicate incremental negative abnormal returns and lower abnormal trading volume but only if the related first-time GC-FS was formulated in a linguistic tone reflecting weak severity—the reason being that the information in the severe GC-EOM is partially new to the financial statement addressees and, therefore, provide additional information content. Bédard, Brousseau, and Vanstraelen (2019) point out that investors perceive GC-FS disclosures as more credible when accompanied by a GC-EOM, implying that a GC-EOM can have incremental value to investors.

The impact of a GC-EOM, given that no additional information is disclosed, can be explained by the existence of a source credibility effect and the theory of professions. Auditors are professionals, with formal education and training controlled by a professional body along with the certification to execute their duties, working in accordance with ethical codes and serving a function to society, therefore, enjoying public trust (Saks 2012; Ackroyd 2016; Quick and Inwinkl 2020). The GC-EOM is a part of the auditor's report, representing a high-credibility source as the auditor is presumed to be a professional, auditing the financial statements of a company on the investors' mission. Hence, the information in the auditor's report seems more credible than identical information in the management's financial statements (Christensen, Glover, and Wolfe 2014; Bédard, Brousseau, and Vanstraelen 2019). The informational value is even enhanced if the disclosed information is negatively connoted (Czapinski and Lewicka 1979). Hence, we formulate our first hypothesis as follows:

H1: The disclosure of a going concern emphasis-of-matter paragraph (GC-EOM) in the auditor's report will have a negative impact on bank directors' perceptions and decisions.

Explanations to responsibilities in the auditor's report

The existence of the audit expectation gap was already proven in many research studies, regardless of time and nation (Humphrey, Moizer, and Turley 1993; Gay, Schelluch, and Reid 1997; Best, Buckby, and Tan 2001; Fadzly and Ahmad 2004; Lin and Chen 2004; Dixon, Woodhead, and Sohlman 2006; Haniffa and Hudaib 2007; Gold, Gronewold, and Pott 2012; Porter, hÓgartaigh, and Baskerville 2012). Generally, the expectation gap describes the gap between auditors' and financial statement users' perceptions concerning the preparation and annual audit of a company's financial statements (IAASB 2011). Financial statement users assign a higher responsibility for the financial statements to the auditor than it is reasonably accomplishable (Porter, hÓgartaigh, and Baskerville 2012; Ruhnke and Schmidt 2014). Recent studies reveal that financial statement users still believe that the auditor is also responsible for the preparation of the financial statements and management report. Consequently, they often expect absolute assurance that material errors will be detected, while in reality, the auditors' objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement and the management report provides an appropriate view of the company's position but not the preparation of the financial statements (Epstein and Geiger 1994; McEnroe and Martens 2001).

In order to improve users' understanding of an audit and narrow the audit expectation gap, the IAASB revised its ISA 700, dealing with the auditor's report. Since 2016, explanations of the responsibilities of the management and auditor and the nature, scope, and procedures of the audit were added to the auditor's report (IAASB 2015b). Due to these disclosures, financial statement addressees shall be more aware that the management is responsible for the preparation of the (consolidated) financial statements and the management report, while the auditor obtains reasonable assurance on whether the (consolidated) financial statements as a whole are free from material misstatements.

We assume financial statement addressees to place more trust in auditors and their reporting as they are presumably of good repute, belonging to a profession that acts

independently. In contrast, the management might act for self-serving reasons, not being very reliable as auditors (Healy and Wahlen 1999; DeZoort and Salterio 2001; Bédard, Brousseau, and Vanstraelen 2019). The reduced trust in information stemming from the management can be explained by a source credibility effect, elucidating that an information of a high-credibility source is more persuasive than of a low-credibility source (Pornpitakpan 2004). Therefore, we assume financial statement readers, in our case—bank directors, perceive higher risks if they are aware that the management is responsible for the preparation of the financial statements than the auditor and will consequently make more unfavorable decisions from the company's point of view, such as conveying a lower willingness to grant loans to the company. Accordingly, we hypothesize that bank directors who receive an auditor's report, including explanations concerning the responsibilities of management, supervisory board, and the auditor, make more unfavorable decisions:

H2: The disclosure of a responsibilities paragraph in the auditor's report describing the management, supervisory board, and auditor's responsibilities will have a negative impact on bank directors' perceptions and decisions.

Strength of the audit committee

In case of companies receiving an audit report containing a going concern note, the financial statement addressees might also consider other non-financial aspects in their decision making. The audit committee is responsible for monitoring the annual audit of the financial statements by the auditor and, therefore, also informed about aspects concerning going concern doubts. Hence, we assume, if there exists doubt about the company's ability to continue as a going concern, the strength of the audit committee becomes more important, impacting on the addressees' decision making to increase confidence.

As it is a key corporate governance mechanism (Agoglia, Douppnik, and Tsakumis 2011), several studies dealing with aspects of corporate governance focus particularly on the audit committee. DeZoort, Hermanson, Archambeault, and Reed (2002) assert that four dimensions emerge when considering the effectiveness of the audit committee: composition, authority, resources, and diligence. In this context, the impact of these

aspects on a broad range of different factors like financial reporting decisions, earnings management, or perceived audit risk is investigated in prior research.

Consistent to Agoglia, Douppnik, and Tsakumis (2011), we differentiate the strength of the audit committee regarding the expertise and independence of its members and activity levels. Therefore, our literature review focuses specifically on the impact of these aspects.²⁴

Many archival studies prove that the audit committee members' expertise has positive effects on the perceptions of investors (DeFond, Hann, and Hu 2005; Karamanou and Vafeas 2005; Aldamen, Duncan, Kelly, McNamara, and Nagel 2012; Singhvi, Rama, and Barua 2013). Additionally, it also has a positive impact on the quality of financial reporting, usually measured by the extent of earnings management (Xie, Davidson III, and DaDalt 2003; Choi, Jeon, and Park 2004; Bédard, Chtourou, and Courteau 2004; Krishnan 2005; Karamanou and Vafeas 2005; Dhaliwal, Naiker, and Navissi 2010; Krishnan, Wen, and Zhao 2011; Sharma, Sharma, and Ananthanarayanan 2011; Keune and Johnstone 2012; Woidtke and Yeh 2013; Bryan, Liu, Tiras, and Zhuang 2013; García-Sánchez, Marínez-Ferrero, and García-Meca 2017; Mohammad and Ahmed 2017; Intintoli, Kahle, and Zhao 2018; Qamhan, Haat, Hashim, and Salleh 2018; Qiao, Chen, and Hung 2018).

Extant research also finds negative associations between the financial and governance expertise of audit committee members and earnings management (Xie, Davidson III, and DaDalt 2003; Bédard, Chtourou, and Courteau 2004), indicating that expertise is negatively associated with restatements (Abbott, Parker, and Peters 2004). In contrast, the studies by Song and Windram (2004), Rainsbury, Bradbury, and Cahan (2009), Ghosh, Marra and Moon (2010), Jamil and Nelson (2011), and Gebrayel, Jarrar, Salloum, and Lefebvre (2018) could not find a significant impact of expertise on the financial reporting quality.

Concerning independence, prior archival studies show that the independence of the audit committee members is positively evaluated by the capital market (Saibaba and Ansari 2011; Chen and Li 2013; El-Sayed Ebaid 2013) with a positive impact on the quality of financial reporting (measured by earnings management activities) (Klein 2002; Lee 2003;

²⁴ The presented studies are only a sample of studies in this broad research area.

Bédard, Chtourou, and Courteau 2004; Choi, Jeon, and Park 2004; Krishnan 2005; Yang and Krishnan 2005; Davidson, Goodwin-Stewart, and Kent 2005; Sharma, Sharma, and Ananthanarayanan 2011; Woidtke and Yeh 2013; Mohammad and Ahmed 2017; Cassell, Myers, Schmardebeck, and Zhou 2018; Qamhan, Haat, Hashim, and Salleh 2018). Certain exceptions include the studies by Gebrayel, Jarrar, Salloum, and Lefebvre (2018) and Intintoli, Kahle, and Zhao (2018) which do not find significant correlation between independence and the extent of earnings management.

Audit committees that consist of independent directors are also less likely to be sanctioned for fraudulent or misleading reporting (Abbott, Park, and Parker 2000) and restatements (Abbott, Parker, and Peters 2004).

Further, the frequency of audit committee meetings is negatively associated with earnings management (Xie, Davidson III, and DaDalt 2003; Vafeas 2005) and perceived audit risk (Stewart and Munro 2007) and increases the probability of detecting the activities of earnings management (Choi, Jeon, and Park 2004). Moreover, Albersmann and Hohenfels (2017) prove that for German companies, both a very low and very high meeting frequency go along with a higher extent of earnings management activities, stating that the optimal frequency of reducing earnings management is four to five meetings a year. Abbott, Park, and Parker (2000) reveal that audit committees that meet at least twice per year are less likely to be sanctioned for fraudulent or misleading reporting. The frequency of meetings is also negatively associated with opinion shopping (Archanbeault and DeZoort 2001). In contrast, Yang and Krishnan (2005) do not find a notable effect between the frequency of meetings and extent of earnings management in the quarterly statements.

Altogether, a strong audit committee can have a positive impact on financial reporting quality by reducing earnings management and evoking positive market reactions. Therefore, our third hypothesis is as follows:

H3: A strong audit committee will have a positive impact on bank directors' perceptions and decisions.

5.4 Research Design

5.4.1 Experiment

Case Materials

To test our hypotheses, we conducted an experiment with a $2 \times 2 \times 2$ between-subjects design. The experiment entailed three treatment variables—GC-EOM (present vs. absent), responsibilities of the management, supervisory board, and auditor (responsibilities paragraph in the auditor's report vs. no paragraph), and the strength of the audit committee (strong audit committee vs. weak audit committee). This resulted in eight experimental conditions with each participant receiving just one condition.

The experimental materials were administered in German, consisting of a general introduction, introducing ourselves (the researchers), and assuring the participants of anonymity and confidentiality. After which all the participants received a description of a fictitious company called Mobile AG, including some general information about its headquarters and subsidiaries, the nature of its business, employees, and stock exchange listing on the Prime Standard of the Frankfurt Stock Exchange. This was followed by a more detailed description of Mobile AG's business situation including some important key indicators like net income, total assets and EBIT²⁵, key facts concerning its corporate governance (*Manipulation of AC*) as well as the firm's auditor. It is specifically mentioned that Mobile AG explains in its risk report²⁶ that its continuance as a going concern depends on the financial support by its mother company due to a redemption payment of a bond.²⁷ Subsequently, the participants were randomly presented with one of the four auditor's reports of the current year (*Manipulation of RESP and GC-EOM*).²⁸

After having read the case materials, the participants were asked to answer some questions concerning the hereinafter-described dependent variables, manipulation checks, and demographic items.

²⁵ We used data of a real world company, but changed it by multiplying with a specific factor.

²⁶ The risk report is part of a company's management report. In Germany, listed companies and privately held companies being not small in terms of the German Commercial Code have to publish yearly a management report ("Lagebericht") that is not part of the financial statements, but has to be in accordance with them. This report contains additional information about the company, e.g. expected developments or opportunities and risks.

²⁷ We discussed several scenarios that could result in a GCU with German auditors in order to choose a realistic scenario and got recommended this specific scenario.

²⁸ For an English version of the case materials see the appendix.

Dependent Variables

After the participants read the information about the fictitious company, they had to answer a few questions: first, the experimental task asked the participants to judge their reliance on the consolidated financial statements and the management report of Mobile AG on a seven-point Likert scale (RELY)—to quantify the likelihood of granting a loan to the company on a scale from 0–100% (LOAN), on recommending non-professional investors to buy shares of Mobile AG on a scale from 0–100% (ADVICE) or investing in the shares of Mobile AG themselves on a scale from 0–100% (INVEST), on evaluating the likelihood that the company can continue as a going concern on a scale from 0–100% (GOING CONCERN), and on evaluating the economic situation of the company on a seven-point Likert scale (ECONOMIC SITUATION).

Treatment Variables

Three different manipulations were applied at two levels: (1) disclosure of responsibilities of the management and supervisory board and the auditor's responsibilities in the auditor's report (*RESP*), (2) GC-EOM paragraph in the auditor's report (*GC-EOM*), and (3) strength of the audit committee (*AC*).

The first treatment variable *RESP* was manipulated at two levels: a paragraph about the management and supervisory board's as well as auditor's responsibilities was either added or not to the auditor's report.

The second treatment variable *GC-EOM* was also manipulated at two levels: a GC-EOM paragraph was either added or not to the auditor's report. This GC-EOM was as follows:

Without qualifying our opinion, we draw attention to Note 4.1 in the group management report which indicates that its continuance as a going concern depends on the financial support by 'Support GmbH,' because a bond due on 3 June 2019 is not redeemable by the mother company on its own according to the liquidity planning. These conditions indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

The last treatment concerned the strength of the audit committee (AC), presented by audit committee characteristics, also manipulated at two levels: strong and weak audit committee. In the case that materials included a strong audit committee, the audit committee was described as follows:

All audit committee members are financially and personally independent of "Mobile AG." They have many years of knowledge and experience in applying accounting principles and internal control procedures and are familiar with the audit. The audit committee meets frequently (eight to nine times per year).

The description of the weak audit committee was as follows:

The audit committee members are independent of "Mobile AG." Two members are former officers of the company. The chair of the audit committee has fundamental experience in applying accounting principles and internal control procedures. The audit committee meets infrequently (one to two times per year).

To improve the quality and validity of our research materials, four international researchers with substantial experience in experimental research were asked to provide feedback. Moreover, five bankers pretested the case. Both led to a number of amendments. The final materials were approved by the Institutional Review Board of the university of one of the authors.

5.4.2 Participants

In this study, we chose German bank directors as participants due to the extremely high relevance of banks in the German economy. The German system is based on three pillars—privately owned banks, banks with government involvement including the regionally focused savings banks, and small credit cooperatives (Hackethal 2004). It is a decentralized universal bank-based financial system (Elsas and Krahnert 2004; Hardie and Howarth, 2009) with universal banks offering financial services and providing a significant share of finance through both debt and equity holdings. Bank borrowing is the largest single external source of finance, especially via long-term loans (Hackethal, Schmidt, and Tyrell 2005; Deutsche Bundesbank 2012).

Banks play a major role in the German corporate governance system for several reasons (Cable 1985; La Porta, Lopez-de-Silanes, Shleifer, and Vishny 2000; Chirinko and Elston 2006; Goergen, Manjon, and Renneboog 2008): they are often represented on the

supervisory boards of companies, possessing the power to elect their own managers to the boards (Dittmann, Maug, and Schneider 2010). Furthermore, they control large blocks of shareholder voting rights, either through direct ownership or indirectly through stockbroking services, i.e., a large amount of shares is deposited by the owners with banks and the bank then acts on behalf of the owners (Franks and Mayer 2001; Becht and Boehmer 2003; Boolaky and Quick 2016). Additionally, banks handle majority of the new issues of marketable securities of the firm, often placing them with their own customers in addition to serving as financial intermediaries and offering investment advisory services. Therefore, bank directors are high-quality subjects representing creditors, investors, and financial intermediaries (Quick and Inwinkl 2020).

Using the BaFin database of banks (Bundesanstalt für Finanzdienstleistungsaufsicht = Federal Financial Supervisory Authority), we were able to identify all registered German banks (1,384) as the data base. Then, we manually collected the names of all German bank directors from bank websites (3,827 as of Spring 2019) and sent an invitation of participation to one director of each bank (647 participations)—briefly introducing our research project by stating the basic information and offering a (personal) web link. After one month, we sent a reminder. This e-mail request resulted in 47 usable responses; thus, the response rate is 7.3%.

Additionally, we identified and contacted 47 bank directors via the career-oriented social networking site “Xing”. Six directors were interested and willing to participate, resulting in a participation rate of 12.8%, while the response rate was 29.8%. We also dispatched a link in a banking group with 2,520 members, inviting them to participate in our research project—249 persons reacted to this link, resulting in 54 usable responses; the response rate of this medium being 9.9% and the participation rate 2.1%.

To test for non-response bias in the group contacted by e-mail, we compared both early and late responses (after sending the second reminder) by performing t-tests for all dependent variables, assuming that late responses serve as indicators of non-response (Wallace and Mellor 1988; Quick and Schmidt 2018). No significant differences were found between these two groups, which does not indicate the existence of a non-response bias.²⁹

²⁹ RELY: mean early respondents = 4.5, mean late respondents = 4.6; $t = -0.156$, $p = 0.877$;
CREDIT: mean early respondents = 23.9%, mean late respondents = 20.7%; $t = 0.460$, $p = 0.648$;

Overall, our final sample consists of 101 participants³⁰ (including participants who failed to answer the manipulation check questions correctly) with the following demographics.³¹

Table 5.1: Demographic items

Variable	N	Mean	SD	Min	Max	Median
YEARS	90	24.18	9.5124	1	46	25
NR_FIRMS	89	1055.20	2055.1890	0	9999	200
NR_ADV	89	944.87	1518.0300	0	9999	500
AGE	90	3.28	1.0280	1	5	3
GENDER	90	1.17	0.3748	1	2	1
EDUCATION	90	3.10	1.0815	1	5	3
POSITION	90	1.47	0.5017	1	2	1
FR_EXPERT	90	5.36	1.1149	2	7	5
AUD_EXPERT	90	4.56	1.5659	1	7	5
RISK	90	4.02	1.2629	1	7	4
TRUST_REPORT	90	4.64	1.3350	1	7	5
TRUST_BOARD	90	4.39	1.1870	2	7	4
TRUST_AUD	90	5.30	1.1558	2	7	6

Notes: YEARS is the number of years the participant has been working in banking; NR_FIRMS is the number of firms the participant has granted credit; NR_ADV is the number of private investors the participant has provided advice for; AGE is the age of the participant (1 = <30, 2 = 30–39, 3 = 40–49, 4 = 50–60, 5 = >60); GENDER is the gender of the participant (1 = male, 2 = female, 3 = diverse); EDUCATION is the highest educational qualification (1 = less than high school, 2 = high school, 3 = college/bachelor, 4 = master or university diploma, 5 = PhD); POSITION is the position of the participant within the bank (1 = board member, 2 = other); FR_EXPERT is the self-assessed financial reporting knowledge on a seven-point Likert scale; AUD_EXPERT is the self-assessed auditing knowledge on a seven-point Likert scale; RISK is the self-assessed risk attitude on a seven-point Likert scale anchored at 1 = risk-averse and 7 = risk-prone; TRUST_REPORT is the self-assessed trust in annual reports on a seven-point Likert scale; TRUST_BOARD is the self-assessed trust in directors of companies on a seven-point Likert scale; TRUST_AUD is the self-assessed trust in auditors on a seven-point Likert scale.

ADVICE: mean early respondents = 12.3%, mean late respondents = 10.1%; $t = 0.421$, $p = 0.676$;
 INVEST: mean early respondents = 9.1%, mean late respondents = 11.3%; $t = -0.480$, $p = 0.633$;
 GOING_CONCERN: mean early respondents = 54.4%, mean late respondents = 47.9%; $t = 0.783$, $p = 0.438$;
 ECONOMIC_SITUATION: mean early respondents = 2.7, mean late respondents = 2.8; $t = -0.456$, $p = 0.650$.

³⁰ Table 5.1 includes participants who failed to answer the manipulation check questions correctly.

³¹ Another 65 participants started to participate but did not answer all relevant questions (questions concerning the dependent variables and manipulation checks). Moreover, we received some responses from participants who explained why they were not willing to participate. Thus, the response rate is higher than the participation rate. Since only 90 participants completed the survey totally, for many analyses, N is smaller than 101.

On average, the participants had over 24 years of practical experience in banking (YEARS mean = 24.18, range = 1–46). The average number of firms for which the subjects had taken part in credit-granting decisions was quite high (NR_FIRMS mean = 1,055.20), however, the experience in such decisions varied considerably (range = 0–9,999). The same applied for investment advice (NR_ADV mean = 944.87, range = 0–9,999). The exact age of the participants could not be requested for ethical reasons; however, the majority were between 40 and 49 years old. Most were male (GENDER mean = 1.17; 1 = male, 2 = female, 3 = diverse) and sat on the board of directors (POSITION mean = 1.47; 1 = board member, 2 = other).³² Most participants' highest education is a master or university diploma (33 participants) (EDUCATION mean = 3.10; 1 = less than high school, 2 = high school, 3 = college/bachelor, 4 = master or university diploma, 5 = PhD). Their self-assessed expertise in both financial reporting and auditing tended to be high (FR_EXPERT mean = 5.36; AUD_EXPERT mean = 4.56; both on a seven-point Likert scale) and, on average, they were neither risk-averse nor risk-prone (RISK mean = 4.02 on a seven-point Likert scale). They placed a high level of trust in auditors (TRUST_AUD mean = 5.30), while the level of trust in annual reports and the board of directors was higher than the average (TRUST_REPORT mean = 4.64; TRUST_BOARD mean = 4.39; all on a seven-point Likert scale).

The experimental materials included three manipulation checks to determine whether the manipulations of the treatment variables were successful. First, the participants had to evaluate the statement that the audit firm indicated has a material uncertainty potentially casting significant doubt on the company's ability to continue as a going concern in the auditor's report on a seven-point Likert scale (1 = strongly disagree; 7 = strongly agree). Second, they had to determine whether the audit firm explicitly described the respective responsibilities of the management and auditor in the provided auditor's report on a similar seven-point Likert scale (1 = strongly disagree; 7 = strongly agree). Sixteen participants failed to pass at least one of these manipulation checks and were excluded from further analyses.³³ The third question—"How do you assess the corporate governance of "Mobile AG" concerning its strength (e.g., independence, expertise)?"—was designed to control for the perceived strength of the audit committee. Answered on

³² While we preferred bank directors and explicitly sent our invitations via e-mail to them, our design also allowed the participation of former bank directors or bank employees with an appropriate profession.

³³ We defined failure as choosing the "wrong" side of the Likert scale. Answers of four (the mean scale) were not excluded.

a seven-point Likert scale (1 = very weak; 7 = very strong), a mean of 4.41 for strong corporate governance compared to a mean of 2.27 for weak corporate governance ($t = 6.5447$, $p = 0.000$) indicated a successful manipulation.

Table 5.2 provides an overview of the eight experimental conditions and the number of participants (excluding manipulation check failures) per cell.

Table 5.2: Number of participants per experimental condition

Experimental Condition	Going Concern Emphasis-of-Matter Paragraph (GC-EOM)	Responsibilities (RESP)	Audit Committee (AC)	Number of participants (after dropping MC-failures)
1	Yes	Yes	Strong	16
2	No	Yes	Strong	6
3	Yes	No	Strong	9
4	No	No	Strong	10
5	Yes	Yes	Weak	13
6	No	Yes	Weak	9
7	Yes	No	Weak	12
8	No	No	Weak	10

5.5 Results

Table 5.3 shows the means of the dependent variables for each experimental condition. At first sight, it is especially obvious that the decisions in the conditions containing a GC-EOM in the provided auditor's report (conditions 1, 3, 5, and 7) tend to be more unfavorable, i.e., the means are lower in the majority of cases, than in the groups without a separate GC-paragraph (except for the dependent variable *RELY*).

Table 5.3: Means and standard deviations of dependent variables by experimental conditions

Variable	RELY		LOAN		ADVICE		INVEST	
Experimental Condition	Mean	Std. dev.	Mean	Std. dev.	Mean	Std. dev.	Mean	Std. dev.
1	4.63	1.36	22.8%	19.4%	11.4%	17.9%	15.7%	15.0%
2	3.83	1.72	36.5%	27.2%	24.3%	20.8%	33.5%	30.3%
3	5.67	1.22	23.4%	22.9%	9.7%	16.4%	12.2%	17.9%
4	4.40	1.35	34.0%	32.0%	23.0%	26.3%	17.1%	25.3%
5	4.85	1.82	11.3%	12.2%	6.2%	11.9%	5.7%	8.0%
6	4.78	0.97	36.6%	20.9%	25.6%	16.7%	30.6%	18.8%
7	4.50	1.38	20.0%	18.2%	5.0%	7.7%	11.7%	9.4%
8	4.80	1.81	47.5%	35.8%	40.0%	31.6%	44.1%	31.2%

Variable	GOING CONCERN		ECONOMIC SITUATION	
Experimental Condition	Mean	Std. dev.	Mean	Std. dev.
1	47.8%	30.2%	2.56	1.09
2	65.0%	24.3%	3.50	1.38
3	62.2%	23.9%	3.00	0.87
4	57.0%	27.7%	3.20	1.31
5	47.7%	23.9%	2.46	1.13
6	65.0%	25.8%	3.33	1.32
7	47.8%	19.7%	2.92	1.24
8	56.4%	28.8%	3.30	1.57

Table 5.4 presents the means of the dependent variables separated by each treatment factor (GC-EOM, responsibilities, audit committee). The direction of the means support the predicted hypotheses H1 and H2: with one exception (*RELY*), the means are lower if a separate GC-EOM is added to the auditor's report. In terms of the responsibility paragraphs, all means of the dependent variables are lower when the responsibilities of the management and auditor are disclosed in the auditor's report. Concerning the impact of strength of the audit committee (H3), the means depict mixed results.

Table 5.4: Means and standard deviations of dependent variables by factor levels

Variable		RELY		LOAN		ADVICE		INVEST	
Factor	Level	Mean	Std. dev.	Mean	Std. dev.	Mean	Std. dev.	Mean	Std. dev.
GC-EOM	Yes	4.84	1.49	19.3%	18.3%	8.2%	14.0%	11.5%	13.1%
	No	4.51	1.46	38.9%	29.2%	28.7%	25.1%	31.1%	27.5%
RESP	Yes	4.61	1.48	24.1%	21.1%	14.5%	17.8%	18.2%	19.6%
	No	4.80	1.49	30.9%	28.9%	19.0%	25.4%	21.0%	25.1%
AC	Strong	4.68	1.46	27.7%	24.6%	15.7%	20.6%	17.9%	21.3%
	Weak	4.73	1.52	27.1%	26.1%	17.5%	23.0%	21.1%	23.4%

Variable		GOING CONCERN		ECONOMIC SITUATION	
Factor	Level	Mean	Std. dev.	Mean	Std. dev.
GC-EOM	Yes	50.4%	25.1%	2.70	1.09
	No	60.1%	26.1%	3.31	1.35
RESP	Yes	53.4%	27.1%	2.82	1.23
	No	55.3%	24.6%	3.10	1.24
AC	Strong	55.7%	27.4%	2.95	1.16
	Weak	53.0%	24.5%	2.95	1.31

To examine whether the differences of means are statistically significant and support our hypotheses, we conduct ANOVAs for each dependent variable. The results are shown in Tables 5.5–5.10.

Table 5.5, Panel A shows the ANOVA results for the bank directors' reliance on the provided financial statements and management report, Panel B the means for each treatment factor, and Panel C the post-hoc analyses. There was no significant impact in any of the treatment variables (GC-EOM: $F = 1.20$; p -value = 0.276/RESP: $F = 0.55$; p -value = 0.460/AC: $F = 0.02$; p -value = 0.876). Thus, our hypotheses H1, H2 and H3 are not supported, indicating that expansions to the auditor's report or the strength of the audit committee do not increase the reliance on the consolidated financial statements and management report.

Table 5.5: Results for the dependent variable RELY

Panel A		ANOVA results			
	Type III sum of squares	Df	F value	P value	
Intercept	3.48	3	0.52	0.669	
GC-EOM	2.67	1	1.20	0.276	
RESP	1.22	1	0.55	0.460	
AC	0.05	1	0.02	0.876	
Residuals		81			
N	85				
Panel B		Means			
Cell					Mean
GC-EOM					4.84
NO GC-EOM					4.51
RESP					4.61
NO RESP					4.80
STRONG AC					4.68
WEAK AC					4.73
Panel C		Post-Hoc Tests			
Comparison					P value (two-tailed)
GC-EOM vs. NO GC-EOM					0.320
RESP vs. NO RESP					0.554
STRONG vs. WEAK AC					0.891

The second dependent variable is the likelihood of the bank directors granting a loan to the fictitious company. Table 5.6, Panel A depicts the ANOVA results concerning the variable *LOAN* with a significant effect for the treatment GC-EOM ($F = 13.23$; p -value < 0.001), while the treatment variables RESP and AC are insignificant (RESP: $F = 0.61$; p -value = 0.439/AC: $F = 0.09$; p -value = 0.762). Panel B displays the means for each treatment factor and Panel C relates the post-hoc analyses.³⁴ In case of a GC-EOM, the means are significantly lower (p -value = 0.000) if a GC-EOM is added to the auditor's report (19.3%) than when the information is only disclosed in the notes to the financial statements (38.9%), supporting H1.

³⁴ We performed t-tests for post-hoc analyses. The application of t-tests requires a normal data distribution and assumes equal variances in the two sub-samples. The assumption of normality is often violated but, because the risk of distortion is low and it is common to use t-tests, we assume our results to be robust.

Table 5.6: Results for the dependent variable LOAN

Panel A		ANOVA results			
	Type III sum of squares	Df	F value	P value	
Intercept	8357.01	3	5.00	0.003	
GC-EOM	7363.51	1	13.23	< 0.001	
RESP	337.16	1	0.61	0.439	
AC	51.38	1	0.09	0.762	
Residuals	45094.69	81			
N	85				
Panel B		Means			
Cell					Mean
GC-EOM					19.3%
NO GC-EOM					38.9%
RESP					24.1%
NO RESP					30.9%
STRONG AC					27.7%
WEAK AC					27.1%
Panel C		Post-Hoc Tests			
Comparison					P value (two-tailed)
GC-EOM vs. NO GC-EOM					0.000***
RESP vs. NO RESP					0.217
STRONG vs. WEAK AC					0.911

In Table 5.7, Panel A, the ANOVA results for the next dependent variable, ADVICE, are presented. The bank directors were asked how likely they would recommend a non-professional investor to buy Mobile AG's shares. Again, the disclosure of a GC-EOM has a notable impact on the bank directors' recommendations ($F = 21.67$; $p\text{-value} < 0.001$). Panel B indicates the means of each factor and Panel C the post-hoc analyses, demonstrating that bank directors tend to give advice less likely in buying the shares of the fictitious firm if a GC-EOM is disclosed (8.2%) than if it is not disclosed (28.7%). Thus, H1 is supported. The treatments RESP and AC have no significant impact on the likelihood of recommendation (RESP: $F = 0.11$; $p\text{-value} = 0.739$ /AC: $F = 0.04$; $p\text{-value} = 0.838$), while the means of the treatment RESP have the right direction concerning our predicted hypothesis H2.

Table 5.7: Results for the dependent variable ADVICE

Panel A		ANOVA results			
	Type III sum of squares	Df	F value	P value	
Intercept	8765.85	3	7.64	< 0.001	
GC-EOM	8290.56	1	21.67	< 0.001	
RESP	42.76	1	0.11	0.739	
AC	16.07	1	0.04	0.838	
Residuals	30985.57	81			
N	85				
Panel B		Means			
Cell					Mean
GC-EOM					8.2%
NO GC-EOM					28.7%
RESP					14.5%
NO RESP					19.0%
STRONG AC					15.7%
WEAK AC					17.5%
Panel C		Post-Hoc Tests			
Comparison					P value (two-tailed)
GC-EOM vs. NO GC-EOM					< 0.001***
RESP vs. NO RESP					0.349
STRONG vs. WEAK AC					0.710

The next condition tested was how likely the bank directors would invest in shares of Mobile AG themselves. Table 5.8, Panel A exhibits the ANOVA results. The disclosure of a GC-EOM ($F = 18.29$; $p\text{-value} < 0.001$) had a remarkable impact on investment decisions taken by bank directors, confirmed by the results of post-hoc tests in Panel C. Panel B shows that 31.1% would invest in the firm's shares if a separate GC-EOM is not disclosed in the auditor's report, while only 11.5% would invest if this was the case. Again, the disclosure of responsibilities (RESP) and the strength of the audit committee (AC) do not have an impact on investment decisions (RESP: $F = 0.00$; $p\text{-value} = 0.980$ /AC: $F = 0.31$; $p\text{-value} = 0.579$), though the means of RESP, shown in Panel B, were in line with our expectations concerning H2.

Table 5.8: Results for the dependent variable INVEST

Panel A		ANOVA results			
	Type III sum of squares	Df	F value	P value	
Intercept	8043.53	3	6.41	< 0.001	
GC-EOM	7657.30	1	18.29	< 0.001	
RESP	0.27	1	0.00	0.980	
AC	129.71	1	0.31	0.579	
Residuals	33903.49	81			
N	85				

Panel B		Means
Cell		Mean
GC-EOM		11.5%
NO GC-EOM		31.1%
RESP		18.2%
NO RESP		21.0%
STRONG AC		17.9%
WEAK AC		21.1%

Panel C		Post-Hoc Tests
Comparison		P value (two-tailed)
GC-EOM vs. NO GC-EOM		< 0.001***
RESP vs. NO RESP		0.561
STRONG vs. WEAK AC		0.502

In Table 5.9, Panel A presents the ANOVA results for the dependent variable GOING CONCERN, asking for the likelihood of continuing as a going concern. The disclosure of a separate GC-EOM had a marginal impact on the bank directors' perceptions of this category ($F = 2.81$; p -value = 0.090) and the direction of means in Panel B supports H1. Thus, the disclosure of a separate GC-EOM in the auditor's report leads to unfavorable perceptions by the bank directors concerning the likelihood of the going concern—supported by the post-hoc tests shown in Panel C. There is neither a significant effect for the treatment variable RESP ($F = 0.01$; p -value = 0.929) nor for the other treatment variable AC ($F = 0.29$; p -value = 0.589).

Table 5.9: Results for the dependent variable GOING_CONCERN

Panel A		ANOVA results			
		Type III sum of squares	Df	F value	P value
Intercept		2117.35	3	1.06	0.370
GC-EOM		1867.23	1	2.81	0.098
RESP		5.34	1	0.01	0.929
AC		195.46	1	0.29	0.589
Residuals			80		
N	84				
Panel B		Means			
Cell					Mean
GC-EOM					50.4%
NO GC-EOM					60.1%
RESP					53.4%
NO RESP					55.3%
STRONG AC					55.7%
WEAK AC					53.0%
Panel C		Post-Hoc Tests			
Comparison					P value (two-tailed)
GC-EOM vs. NO GC-EOM					0.090*
RESP vs. NO RESP					0.732
STRONG vs. WEAK AC					0.628

The last dependent variable is the assessment of the current economic situation of the company, the ANOVA results of which are presented in Table 5.10, Panel A. As before, only the treatment variable GC-EOM has a significant impact on the bank director's perception concerning the economic situation of Mobile AG ($F = 4.69$; p -value = 0.033), while the disclosure of responsibilities ($F = 0.53$; p -value = 0.468) or the strength of the audit committee ($F = 0.01$; p -value = 0.915) do not influence the assessment of the economic situation. The means are presented in Panel B, showing that the economic situation is evaluated worse if a GC-EOM is disclosed, supporting our predicted hypothesis H1. The ANOVA results are confirmed by the post-hoc tests in Panel C.

Table 5.10: Results for the dependent variable ECONOMIC_SITUATION

Panel A					
ANOVA results					
	Type III sum of squares	Df	F value	P value	
Intercept	8.56	3	1.94	0.130	
GC-EOM	6.90	1	4.69	0.033	
RESP	0.78	1	0.53	0.468	
AC	0.12	1	0.01	0.915	
Residuals	119.25				
N	85				
Panel B					
Means					
Cell	Mean				
GC-EOM	2.70				
NO GC-EOM	3.31				
RESP	2.82				
NO RESP	3.10				
STRONG AC	2.95				
WEAK AC	2.95				
Panel C					
Post-Hoc Tests					
Comparison	P value (two-tailed)				
GC-EOM vs. NO GC-EOM	0.023**				
RESP vs. NO RESP	0.300				
STRONG vs. WEAK AC	0.990				

In summary, the results confirm our first hypothesis, reporting that the disclosure of a GC-EOM in the auditor's report will have a negative impact on bank directors' decisions from the company's point of view. Except for the first dependent variable, representing the reliance in the presented financial statements, the bank directors make more unfavorable decisions or have worse perceptions of Mobile AG's situation due to a source credibility effect. The auditor's report is a more credible source, thereby explaining why the information additionally disclosed by the auditor is assessed higher by the bank directors, resulting in different decisions.

The results also indicate a tendency that bank directors take more unfavorable decisions if the responsibilities of the management and the auditor are clearly defined and disclosed in the auditor's report (see Table 5.4). If they are aware that the financial statements are prepared by the management making self-serving decisions, they trust less in the company and act more carefully in their decision making. However, the results are not statistically significant. We assume bank directors to be highly experienced financial statement addressees who are aware of the responsibilities of the management and auditor

regardless of the information in the auditor's report. Therefore, since this information might not be new to them, the perceptions and decisions between these groups do not present significant differences. Hence, our results do not support our second hypothesis H2.

Further, our results do not support our last hypothesis H3, hence, the strength of the audit committee does not have an impact on the bank directors' perceptions and decisions in this scenario. A possible explanation for this result is a fundamental criticism of the audit committee's effectiveness in general (DeZoort, Hermanson, Archambeault, and Reed 2002), therefore, being perceived by stakeholders is less important than other mechanisms (Cohen, Krishnamoorthy, and Wright 2002). Moreover, the organization of the two-tier corporate governance system—that is predominant in Germany—might result in absent trust in the supervisory board and, consequently, may have a spillover effect to the perception of the audit committee being a part of the supervisory board. For instance, German boards consist of up to 20 members, whereof up to 50% are labor representatives who might have a lower level of expertise in auditing and accounting. This organizational aspect might lead to information asymmetries within the board, proving difficult to involve every member appropriately (Jungmann 2006). As the audit committee is only a part of the supervisory board, the bank directors might not react to different characteristics of the audit committee but only to the strength of the supervisory board as a whole. Moreover, German directors hold this office part-time and are often members of several boards simultaneously.³⁵ These aspects might prevent bank directors from not basing their decisions on the strength of the audit committee.

5.6 Conclusion

In the last decade, the IAASB revised some of its standards concerning auditors' reporting. One material amendment was the revision of the ISA 570, extending the reporting on a company's GCU by establishing the duty for auditors to add a separate GC-EOM paragraph to the auditor's report. While this information is not new to financial statement addressees, as the information is also included in the notes to the financial

³⁵ In Germany it is allowed to have up to 10 board of directors' seats at the same time (Section 100 of the German Stock Corporation Act).

statements of the company, it might be evaluated higher due to its prominent position in the auditor's report.

Another amendment was the revision of the ISA 700, implementing the duty to add explanations of the responsibilities of the management and auditor to the auditor's report to reduce the audit expectation gap.

Therefore, we experimentally investigate the impacts of both a GC-EOM and a responsibilities description on financial statement addressees' perceptions and their decision-making behavior. We use German bank directors as banks have an outstanding role in Germany as investors, providers of capital, and finance intermediaries all at the same time. Further, they are an important part of the German corporate governance system (BooLaky and Quick 2016). Another important part of corporate governance is the audit committee of a company's supervisory board. Prior research proves a positive impact of the strength of the audit committee regarding its financial expertise, independence and activity level on a company's performance, financial reporting decisions, and stake- and shareholders' reactions (Westphal and Zajac 1998; Bédard, Chtourou, and Courteau 2004; DeFond, Hann, and Hu 2005; Agoglia, Douppnik, and Tsakumis 2011).

Therefore, our study investigates the impact of a GC-EOM and a responsibilities paragraph in the auditor's report as additional sources of information as well as the strength of the audit committee on German bank directors' perceptions and decisions, using the method of an experiment. Our findings support the disclosure of a GC-EOM in the auditor's report, as intended by the IAASB with its revision of the ISA 570. Bank directors tend to make different—for the company more unfavorable—decisions in case a GC-EOM is disclosed because of a source credibility effect, proving the decision usefulness of a separate GC-EOM in the auditor's report. The auditor is regarded as a highly credible source because of their independent and monitoring role in the financial reporting process. Hence, financial statement addressees may evaluate information published by the auditor higher than the information published by a company's management (Duréndez Gómez-Guillamón 2003; Wallace 2004; Fan and Wong 2005).

In contrast, we do not find impacts of explanations of the responsibilities in the auditor's report because bank directors are informed parties and are most likely aware of disregarding this related paragraph in the auditor's report, i.e., there is no related

expectation gap for this subject group. Neither do we find impacts of the strength of the audit committee on the bank directors' perceptions and decisions, which may indicate missing trust in the two-tier corporate governance system.

Our study is not without limitations. In reality, additional data is required to decide on granting loans to a company than what is presented in our case materials. However, in research projects, it is important to find the right amount of information provided to make a decision while ensuring to avoid overtaxing the participants' willingness to participate; especially since bank directors have a limited contingent of time resources to participate in such research studies. Hence why the information provided was limited; however, the inclusion of different information could potentially result in varied outcomes. Moreover, the German banking system and corporate governance system differ from the systems in Anglo-American countries. Therefore, our findings may differ using bank directors from the USA, UK, Australia, or New Zealand (Quick and Inwinkl 2020). Our results could also differ using different subjects (e.g., non-professional investors or financial analysts), a different industry in our case scenario, or another event evoking GCU. Further, the reliability of our results might be limited due to the relatively small sample size (Simmons, Nelson, and Simonsohn 2011), which can be compensated by using highly knowledgeable participants as bank directors. However, we were able to find highly significant results and contribute to this research area. Another relevant aspect might be that the difference in strong and weak audit committees in our setting were not great enough to create confidence³⁶, hence, contributing as a limitation as well.

Future research can, perhaps, focus on other financial statement user groups to investigate whether different addressees would react differently to the disclosure of a GC-EOM or whether the audit committee has significant impacts. While Anandarajan, Viger, and Curatola (2002) investigated alternative going concern reporting formats in Canada and the present research employed German subjects as representatives of European countries, another opportunity for future research lies in using bank directors belonging to different banking and corporate governance systems or utilizing archival data to investigate the impact of a GC-EOM.

³⁶ Our description of the audit committee (strong vs. weak) is based on Agoglia, Douppnik, and Tsakumis (2011).

5.7 Appendix

EXHIBIT A: Experimental Case [Treatments in squared brackets]

General

“Mobile AG” is an automotive supplying company with its headquarters located in Frankfurt, Germany and 80 offices in 40 countries around the world. It produces components for engines, gearboxes, and undercarriages as well as solutions of friction and anti-friction bearings for a broad range of industry applications. The firm’s strategy for the future focuses on environment-friendly engines, urban and interurban mobility, and the energy chain.

“Mobile AG” has 42,000 employees and its current labor agreement in Germany will end on February 28, 2020.

The stocks of “Mobile AG” are listed in the Prime Standard of the Frankfurt Stock Exchange and is part of the SDAX index. The financial statements are prepared in accordance with the International Financial Reporting Standards (IFRS).

Business situation

“Mobile AG” increased its sales from €6,338 million (2017) to €7,010 million (2018). The net income decreased from €59 million to €43 million. In comparison to 2017, the total assets have marginally decreased and summed up to €5,769 million at the year end of 2018 (2017: €5,782 million). In 2018, a cash flow of minus €289 million was generated (2017: €33 million). The investment volume for the forthcoming business year is high.

Some further important key indicators of “Mobile AG” (2017 data in parentheses) for the business year 2018 are as follows:

- EBIT: €76 million (€77 million)
- Earnings per share: €0.12 (€0.14)
- Return on equity: 3.9% (4.3%)
- Debt-to-Capital Ratio (Debt Capital/Total Assets): 0.88 (0.83)
- Price Earnings Ratio 12 (11)

“Mobile AG” is fully owned by “Support GmbH.” In its risk report, “Mobile AG” explains that its continuance as a going concern depends on financial support by “Support GmbH” because a bond of 150 million due on 3 June 2019 cannot be redeemed by the mother company alone according to its liquidity planning.

Corporate Governance

The management board of “Mobile AG” consists of nine members. These chairpersons receive a fixed basic salary and some fringe benefits like cars. Additionally, the

supervisory board, in December, annually determines a performance-related compensation which utilizes group earnings as the performance indicator.

The supervisory board consists of 20 members, 10 of whom represent employees. All members receive a fixed payment at the year end and a reimbursement for expenses. The supervisory board has established an audit committee that addresses the monitoring of the accounting process and the audit among other things.

[STRONG] All audit committee members are financially and personally independent of “Mobile AG,” possessing many years of knowledge and experience in applying accounting principles and internal control procedures in addition to being familiar with the audit. The audit committee meets frequently (eight to nine times per year).

[WEAK] The audit committee members are independent of “Mobile AG.” Two of them are former officers of the company while the chair has fundamental experience in applying accounting principles and internal control procedures. The audit committee meets infrequently (one to two times per year).

Auditor

Since 2012, the audit firm ABCD has been responsible for the statutory audit. ABCD, one of the Big 4 audit firms which operate on the German audit market, has always issued an unqualified audit opinion.

ABCD performs the statutory audit in accordance with the relevant norms.

ABCD was elected in the general meeting and appointed by the supervisory board of “Mobile AG.”

The audit fee paid to ABCD for the statutory audit of the financial statements 2018 is €3.4 million. Moreover, ABCD earned €326,250 for the provision of non-audit services in the same year.

EXHIBIT B: Independent Auditor’s Report [Treatments in squared brackets]

Opinions

We have audited the consolidated financial statements of “Mobile AG” and its subsidiaries (the Group). In addition, we have audited the group management report of “Mobile AG.”

In our opinion, on the basis of the knowledge obtained in the audit,

- the accompanying consolidated financial statements comply, in all material respects, with the IFRS as adopted by the EU, ... and, in compliance with these requirements, give a true and fair view of the assets, liabilities, and financial position of the Group as on December 31, 2018, and of its financial performance for the financial year from January 1 to December 31, 2018, and

- the accompanying group management report as a whole provides an appropriate view of the Group's position. In all material respects, this group management report is consistent with the consolidated financial statements, complies with German legal requirements and appropriately presents the opportunities and risks of future development.

[Emphasis of Matter]

Without qualifying our opinion, we draw attention to Note 4.1 in the group management report which indicates that its continuance as a going concern depends on financial support by "Support GmbH" because a bond due on 3 June 2019 is not redeemable by the mother company on its own according to the liquidity planning.

These conditions indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

[Responsibilities of the Management and Supervisory Board for the Consolidated Financial Statements and the Group Management Report]

The management is responsible for the preparation of the consolidated financial statements that comply... with IFRSs... and that the consolidated financial statements, in compliance with these requirements, give a true and fair view of the assets, liabilities, financial position, and financial performance of the Group. ...

In preparing the consolidated financial statements, the management is responsible for assessing the Group's ability to continue as a going concern. They also have the responsibility for disclosing, as applicable, matters related to the Company's continuation as a going concern. ...

Furthermore, the management is responsible for the preparation of the group management report that, as a whole, provides an appropriate view of the Group's position and is, in all material respects, consistent with the consolidated financial statements, complies with German legal requirements, and appropriately presents the opportunities and risks of future development. ...

The supervisory board is responsible for overseeing the Group's financial reporting process for the preparation of the consolidated financial statements and of the group management report.

[Auditor's Responsibilities for the Audit of the Consolidated Financial Statements and Group Management Report]

Our objectives are to obtain reasonable assurance on whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and whether the group management report as a whole provides an appropriate view of the Group's position and, in all material respects, is consistent with the consolidated financial statements and the knowledge obtained in the audit, complies with the German legal requirements and appropriately presents the opportunities, and risks of future development as well as to issue an auditor's report that includes our opinions on the consolidated financial statements and on the group management report.

...

We exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- ...
- Conclude on the appropriateness of the management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern.

**6. Berichterstattung von Aufsichtsrat und Vorstand - „Der Ton macht die Musik“:
eine textimmanente Analyse**

6.1 Publikationsdetails

Heilmann, M./ Höfmann, M./ Pott, C. (2020). Berichterstattung von Aufsichtsrat und Vorstand – „Der Ton macht die Musik“: eine textimmanente Analyse.

WPg Die Wirtschaftsprüfung, 12, 707-714.

7. Conclusion

This dissertation deals with the recent regulatory changes in audit reporting, namely the implementation of key audit matters (paper 1-3) and the duty to disclose a separate going concern emphasis of matter paragraph if a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern (paper 4). Furthermore, it focuses on the communication of the management and the supervisory board with the financial statements' addressees (paper 5).

The *first* paper (chapter 2) examines interacting effects of KAM disclosure and stock ownership on AC members' decision making. The results show that non-stock-owning AC members tend to agree less with the management's income-increasing accounting behavior if KAMs are disclosed in the auditor's report. Generally, it is the AC's duty to oversee the financial reporting process on behalf of the investors. Because KAMs get more attention from investors, the AC members decide even more conservative in case of a KAMs disclosure. Stock-owning directors do also have an interest in maximizing their personal outcome, that is why they decide differently to non-stock-owning directors. In this scenario, KAMs can be used as disclaimer indicating a forewarning effect, so that the stock-owning AC members can legitimize a self-serving decision. Thus, we provide evidence that the impact of KAMs depends on aspects of financial independence.

The *second* paper (chapter 3) investigates whether the disclosure of KAMs increases the reporting quality of the report of the supervisory board. Because KAMs are selected from matters communicated with those charged with governance, we assumed KAMs will also be mentioned in the report of the supervisory board, where it is explained how the board directors dealt with these matters in line with their oversight duty. Our analysis shows no significant increase of the reporting quality in the first year of mandatory disclosure, because KAMs are rarely mentioned in the reports, and, in case they are, no further information is provided for the financial statement users. Hence, we provide important implications for the supervisory board to refer to KAM reporting in their report in order to provide useful information for addressees and increase their reporting quality.

The *third* paper (chapter 4) gives an overview of the implementation of KAM reporting in Germany in the first two years of mandatory disclosure. We focused on the development of KAM reporting with regard to disclosed number of KAMs, topics focused as KAMs and textual implementation in order to analyze the uniqueness of KAM

reporting. The results reveal that there exists room for improvement to create an individual, decision-useful report. However, if the KAM sections remain similar concerning the focused topics and their wording over the years, the IAASB's anticipated purpose to enhance the communicative value of the auditor's report was not achieved.

The *fourth* paper (chapter 5) focuses on another new regulatory change in audit reporting, namely the addition of a separate going concern emphasis of matter paragraph in the auditor's report (GC-EOM) if an adequate disclosure of a material uncertainty is made in the financial statements. In this study, it is experimentally investigated whether such a paragraph influences bank directors' decision making, though it contains no new information. Additionally, the impact of a responsibilities paragraph in the auditor's report and the strength of the audit committee are analyzed. The results imply strong evidence that a GC-EOM influences bank directors' decision making due to a source credibility effect, while a responsibilities paragraph and the strength of the audit committee do not have an impact on the bank directors' perceptions and decisions.

While the first four papers deal with communications by the auditor or at least impacts of auditor's reporting on other stakeholders, the *fifth* paper (chapter 6) focuses on aspects of communication by a firms' representatives, the management and the supervisory board. Specifically, the letters to the shareholders and the reports of the supervisory board are analyzed with regard to their text length, readability and sentiment over a period of ten years. In sum, both reports are difficult to read and there exists room for improvement concerning the verbal skills of the representatives' communication tools.

To summarize, this dissertation provides fruitful evidence that KAMs and GC-EOMs have impacts on stakeholders' perceptions and their decision making, contributing to the current debate on the effectiveness of the novelties in auditor's reporting. However, the current practical implementation of KAMs runs the risk to become a standardized report, reducing the potential to provide individual information. Therefore, further research is needed to investigate the development of KAM disclosure over the years.

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