Do investors value higher reporting quality, and can expanded audit reports unlock this value? A sustainability reporting reflection

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Abstract

This article review provides an overview of the works of Elliott et al. (2020), “Do investors value higher reporting quality, and can expanded audit reports unlock this value?” in the Accounting Review. It then provides a reflection on the sustainability reporting and assurance arena. The study finds that, with the claims made by the international sustainability standards boards, the sustainability reporting and assurance may become more investor-centric than stakeholder-oriented. The need for sustainability reporting comparison and standardization opens avenues for future research as highlighted in the article review.

Keywords: Reporting Quality; Sustainability Standards; Assurance; Expanded Audit Reports; Investor Value.

Elliott, Fanning and Peecher present, through an experimental study, the interconnectedness between corporate higher financial reporting quality (FRQ) and investor perception. And how expanded audit reports can enhance a such relationship. The experiment included some three hundred twenty-five students at a large state university enrolled in a financial statement analysis course near semester end. These students represented the sample of informed investors.

Participants were each provided with an envelope including background information about two hypothetical medical equipment firms, a first-mover and a laggard pertaining to the development of a new technologically advanced medical device. Additionally, participants received- for each firm- a set of key performance ratios (KPIs), an income statement and statement of financial position and an auditor report with disclosures on critical audit matters (CAMs). One firm reported higher financial reporting quality (FRQ), whereas the other reported lower FRQ. The differences in FRQ were attributable to estimating the warranty and bad debts expenses. The financial statements showed that the higher (lower) FRQ firm maintained (lowered) the percentage of both expenses to sales between the current and previous fiscal years. As a consequence, the lower FRQ firm reported equally higher earnings growth and higher profit margin KPIs than the higher FRQ firm counterpart.

Both firms received an unqualified opinion by the audit, with FRQ commentary either given or absent. The report with

commentary conditions highlighted to the participants the two CAM items (warranty and bad debts). While the higher FRQ firm's management estimates fell in the median of the auditor's acceptable range, the lower FRQ firm's management estimates were at the lowest acceptable range as an indicator in the audit report commentary. The other set of audit reports with no commentary, only provided an unqualified audit opinion, stating the two CAMS, while withholding commentary.

Each participant was then asked to derive the fundamental value (FV) based on Elliot et al. (2014) for each of the two hypothetical firms, while stating the estimates utilized for completing the residual earnings valuation model per firm. Participants adjusted the firm's earnings significantly downward for the lower FRQ than for the higher FRQ, both when provided with the audit commentary and when not. However, such difference was slightly more pronounced among participant estimates who received the audit report with CAMs commentary. This indicates that investors are able to capture the actual FRQ and omit optimistically biased estimates in the financial statements.

Each participant was then asked to indicate the maximum bid price willing to pay (WTP) for each share if $100,000 was inherited. Elliott et al. (2020) argue that investors will increase their WTP to purchase shares for firms with *credibly* higher FRQ, with auditor commentary on CAMs enhancing such credibility.

$$\text{Price WTP} = f(\text{Estimated FV}) + g(\text{Perceived FRQ})$$

It was found that a large proportion of investors are WTP higher than the firm's estimated FV for a firm with higher FRQ and audit commentary, as compared to the firm with low FRQ with audit commentary. Additionally, they found that a slightly higher proportion of investors are WTP more than FV for firms with lower FRQ and no commentary than their counterparts with higher FRQ and no commentary. Hence, this supports the hypothesis that investors are WTP higher prices for shares of a firm with higher FRQ than that of lower FRQ when an auditor comments on such quality versus not commenting.

Elliott et al. (2020) asked participants about their admiration and level of satisfaction with each firm's financial reporting practices (as a proxy for positive affective reactions) and the level to which management was optimistic about their warranty and bad debts estimates (as a proxy for positive cognitive beliefs). A structural equation model (SEM) was constructed by combining those latent (unobservable) variables, with the dependent observable variable WTP scaled by FV, the independent variable FRQ commentary and a latent mediator Cooperation (a Likert scale on investor's perception to management's level of financial statement information conveying cooperation). SEM results indicated that with FRQ commentary, firms with higher FRQ received both higher positive affective (admiration) reactions and cognitive beliefs (on management financial reporting objectively of estimates) compared to the lower FRQ counterparts. A follow-up test showed that investors value cooperative behaviors in FRQ, thus they are WTP higher for shares of firms that credibly use higher FRQ accompanied with auditor commentary on CAMs.

With the developments underway in the sustainability reporting framework/standards, especially through IASBs newly developed International Sustainability Standards Board (ISSB), the study of the interconnectedness between value creation, environmental urgency and sustainability reporting quality is more demanding than ever. ISSB strives itself as addressing the calls of international *investors* for high-quality, transparent, reliable and comparable reporting of corporate climate and ESG matters. In the meantime, ISSB drafted its first sustainability reporting standards IFRS S1 “General Sustainability-related Disclosure Requirements” and IFRS S2 “Climate-related Disclosures”.

Yet competitive, the sustainability reporting assurance standards, providers and market are still in their growing stages (Cohen and Simnett, 2015). Sustainability/integrated reporting and assurance standards have gained criticism in prior literature through the works of Flower (2015) and Thomson (2015), and messages of caution in the works of De Villiers et al. (2017) and Adams (2015). Hence, quantitative and qualitative studies on sustainability reporting standards and assurance and their connectedness with environmental urgency, climate change, (*lack of*) value generation, reporting quality, and sustainability performance are becoming vital given the developments underway in assurance and reporting standardization. Future research needs to address whether the calls for sustainability reporting quality SRQ are action-based, addressing COP26/27 calls and not merely a quality (comparable, transparent, reliable) reporting practice to *investors* and *capital providers.* Future studies may also explore whether the current IFRS sustainability standards underway are not another own version of sustainability reporting that may obstruct the innovative nature of sustainability reporting.

The use of experimental studies in investors’ reactions to sustainability reporting and assurance, as outlined by De Villiers et al. (2021) is novel and potentially opens avenues for future research. The current literature, mostly not experimental, with the notable exception of De Villiers et al. (2021), studied, investors’ value ascribing to firm inclusion in sustainability indexes/funds (for instance: Biktimirov and Afego, 2022; Hawn et al., 2018; Durand et al., 2019; Hartzmark and Sussman, 2019; Wai Kong Cheung, 2011), having sustainability assurance (for instance: Reverte, 2021; Thompson et al., 2022) and carbon emissions (ex: Bolton and Kacperczyk, 2021). Due to the dearth of experimental studies on the investor, sustainability reporting/assurance arena, it opens up fruitful avenues for future studies.

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