

The Merits of a Pass-Fail Audit Report: An Experimental Investigation of Alternatives to the Must-Pass Model

To protect investors, the SEC requires publicly-traded companies to have an unqualified audit opinion associated with that company's financial statements. In contrast, investors demand more gradient information in audit reports. We conduct an experiment in the tradition of experimental economics that models the current must-pass market and compares it to two alternatives: (1) a true pass-fail market in which auditors can choose between a positive or negative audit opinion, and (2) a gradient market in which auditors can issue a more continuous assessment, rather than a discrete pass-fail opinion. We find no differences between investor decisions in the must-pass and pass-fail markets. However, investors make less efficient and more suboptimal decisions when audit reporting is more gradient compared to the other conditions. Our findings suggest both that investors' demands for more gradient audit reporting may be misguided and that regulators' prohibition against qualified audit opinions may be unwarranted.

Kendall O. Bowlin
The University of Mississippi
kobowlin@olemiss.edu

Jeffrey Pickerd
Brigham Young University
jeffrey.pickerd@byu.edu

Dan Rimkus*
University of Florida
dan.rimkus@warrington.ufl.edu