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“Transparency: with Available, Reliable, Comparable and Re-usable Data”

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Date & Time: 3/22/2012 4:45PM

Track: Academic Research and Insight

Session Title: ACDM15. A Relative Cost Framework of Demand for External Assurance of XBRL

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How much will users pay for external assurance of XBRL filings?

- ▶ When you went out for dinner last night were you willing to pay more for the first course than for the main course?
- ▶ Rule of thumb in restaurant industry is that appetizers cannot cost more than 30% of main course. Behavioral considerations determine demand behavior.
- ▶ Similarly, need to adopt a relative cost perspective on who provides assurance of XBRL filings and what users will pay for it.

A broader perspective on XBRL assurance

- ▶ The research literature on XBRL assurance has focused on the standards that should be followed by external auditors (Srivastava and Kogan, 2010; Boritz and No, 2011).
- ▶ Less attention paid to the costs of obtaining that assurance, and especially, the cost relative to that of preparing XBRL filings in the first place.
- ▶ Also, in the absence of mandated external assurance, who will provide confidence?

Sources of confidence on XBRL filings



External auditors only one source of assurance

- ▶ As long as the SEC does not mandate that a company's external auditor must provide independent assurance regarding its XBRL filings, whether to ask that auditor to provide XBRL assurance services, or a lesser scope AUP engagement, is a cost/benefit decision to be made by management on the basis of the relative cost of the various providers of confidence.
- ▶ We develop a conceptual model of the decision facing management.

Conceptual framework based on two relative cost comparisons

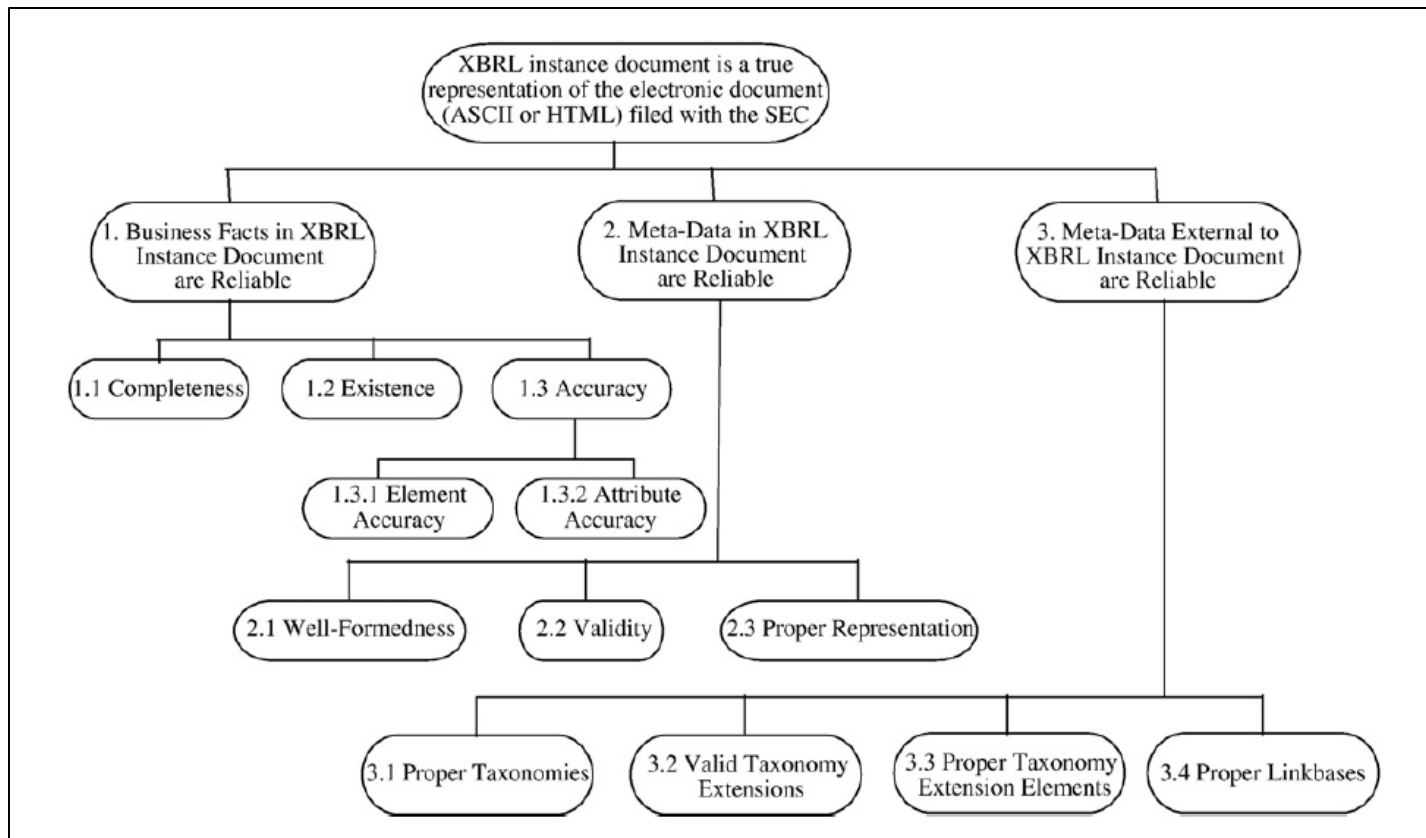
- ▶ **The external cost relative to preparation cost comparison:** The cost to the filer of obtaining independent assurance on XBRL filings from an external auditor relative to the company's cost of preparing those filings.
- ▶ **The external cost relative to internal cost comparison:** The cost of obtaining independent assurance on XBRL filings from an external auditor relative to the cost of using internal providers of confidence.

Cost of preparing XBRL filings not particularly high

| | 1 st submission/ block-text footnotes & schedules | Subsequent submission/ block- text footnotes & schedules | 1 st submission/ detailed footnotes & schedules | Subsequent submission/ detailed footnotes & schedules |
|---------------------------------------|--|---|--|--|
| Preparation face financials | \$31,370 | \$4,310 | \$4,310 | \$4,310 |
| Preparation footnotes | \$1,750 | \$1,750 | \$17,500 | \$8,750 |
| Preparation schedules | \$250 | \$250 | \$1,750 | \$875 |
| Software and filing agent services | \$6,140 | \$6,140 | \$6,140 | \$6,140 |
| Web site posting | \$1,000 | \$1,000 | \$1,000 | \$1,000 |
| Total cost | \$40,510 | \$13,450 | \$30,700 | \$21,075 |
| Upper bound | \$82,220 | \$21,340 | \$60,150 | \$37,940 |

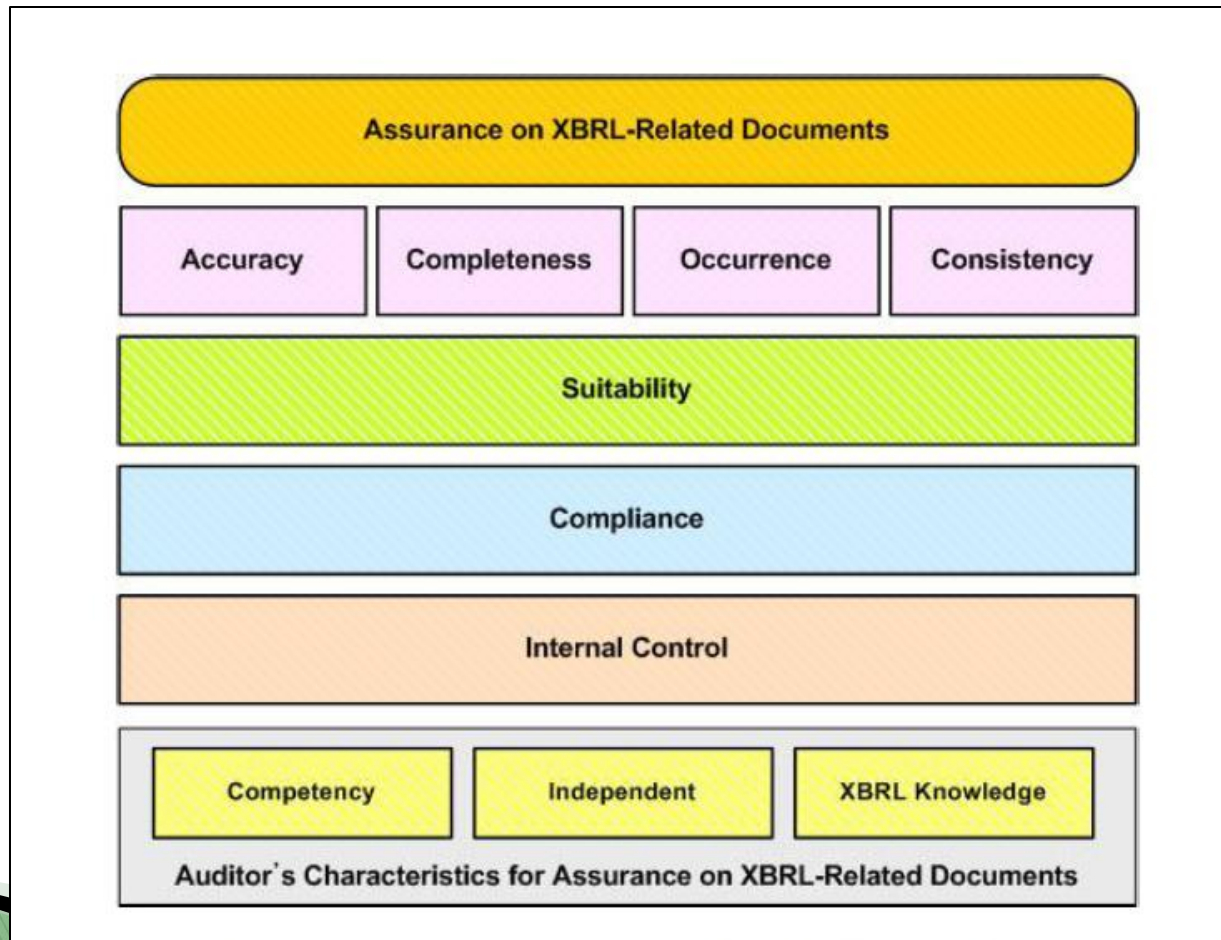
Compare to complexity of frameworks for full assurance

► Srivastava and Kogan (2010):



Frameworks for full assurance of XBRL filings cont.

- ▶ Boritz and No (2011):



AICPA proposed principles and criteria for XBRL-formatted info.

- ▶ **Completeness**—*All required information is formatted at the required levels as defined by the entity's reporting environment. Only permitted information selected by the entity is included in the XBRL files.*
- ▶ **Mapping**—*The elements selected are consistent with the meaning of the associated concepts in the source information in accordance with the requirements of the entity's reporting environment.*
- ▶ **Accuracy**—*The amounts, dates, other attributes (for example, monetary units), and relationships (order and calculations) in the instance document and related files are consistent with the source information in accordance with the requirements of the entity's reporting environment.*
- ▶ **Structure**—*XBRL files are structured in accordance with the requirements of the entity's reporting environment.*
- ▶ Under these principles, the AIPCA lists a total of 24 specific criteria: two for completeness, eight for mapping, nine for accuracy, and five for structure.

Compare preparation cost to that of Agreed Upon Procedures

- ▶ *“Current ranges for non-detail tagged “Agreed Upon Procedures” engagements are running anywhere from \$25,000 to \$50,000 per, with anecdotal evidence that the base price is moving upward pretty quickly. I fully expect that number to increase dramatically for detail tagged XBRL.”* Dan Roberts, past chairman of the XBRL US steering committee
- ▶ *“Typical year 1 engagement takes 2-3 elapsed weeks and range from 80-120 hours.*
- ▶ *Typical year 2 engagement (detailed footnote tagging) takes 4-5 elapsed weeks and range from 250-400 hours.”* Matthew Slavin, Ernst & Young
- ▶ Using the \$250 hourly rate used by the SEC in their cost calculations implies AUP costs ranging from \$20,000–\$30,000 in the first year and \$62,500–\$100,000 in the second year.

Behavioral considerations

- ▶ In theory, the decision on whether to utilize an external auditor for assuring a company's XBRL filing is a function of the costs of that assurance compared against the tangible and intangible future benefits of that assurance.
- ▶ As such, the costs of preparing the XBRL filings are a sunk cost and should be irrelevant to this decision.
- ▶ In practice it is hard to believe managers would pay more for assurance than for preparation in the first place.

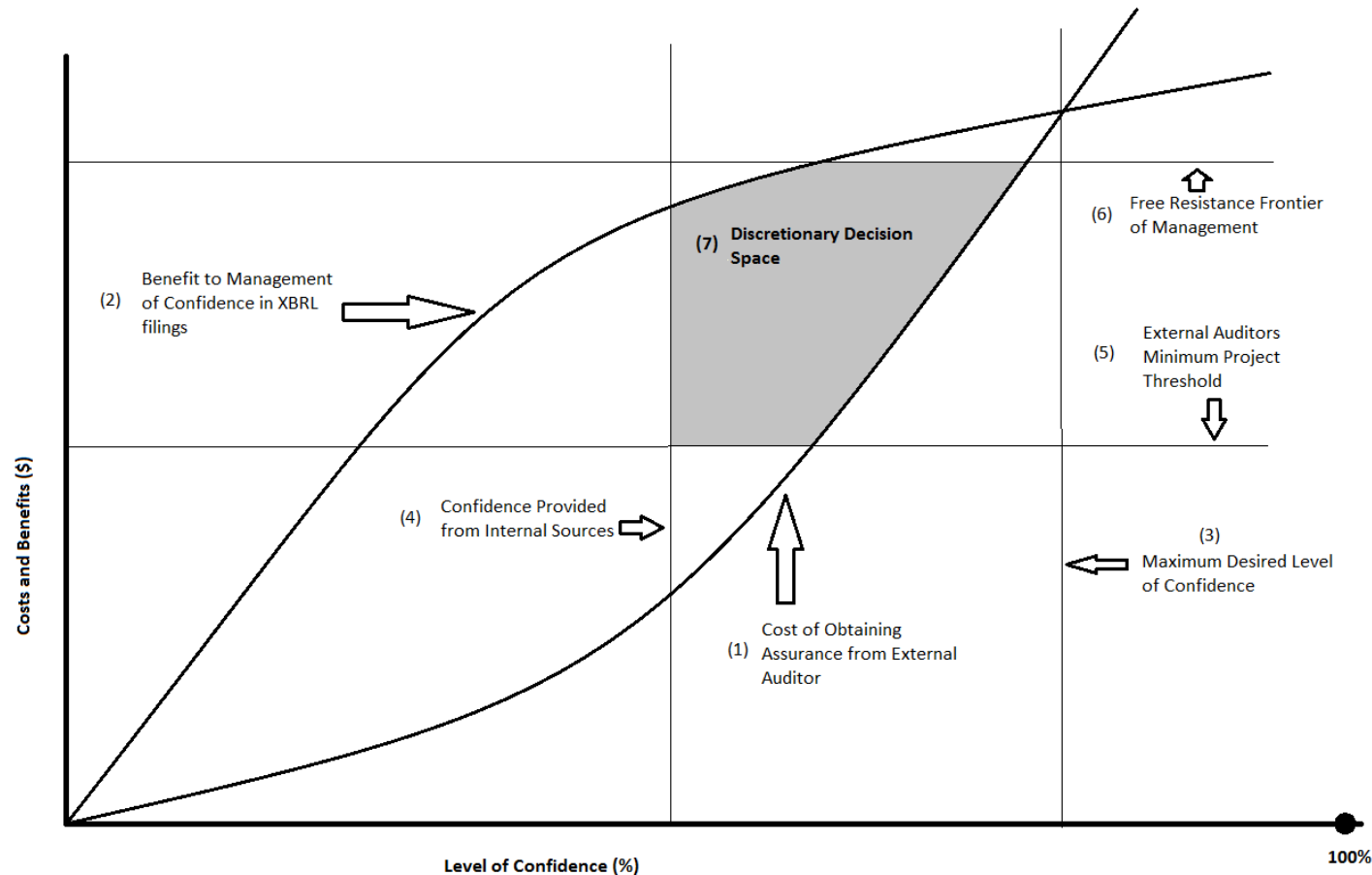
The external cost relative to preparation cost comparison

- ▶ Whatever normative theory may say, in practice, managers will generally be willing to spend only a fraction of the original preparation cost on assurance, especially since the dollar value of avoided litigation or reputation damage is difficult to quantify.
- ▶ No evidence thus far that expiry of safe harbor provisions is increasing demand—or willingness to pay—for external assurance of XBRL filings.

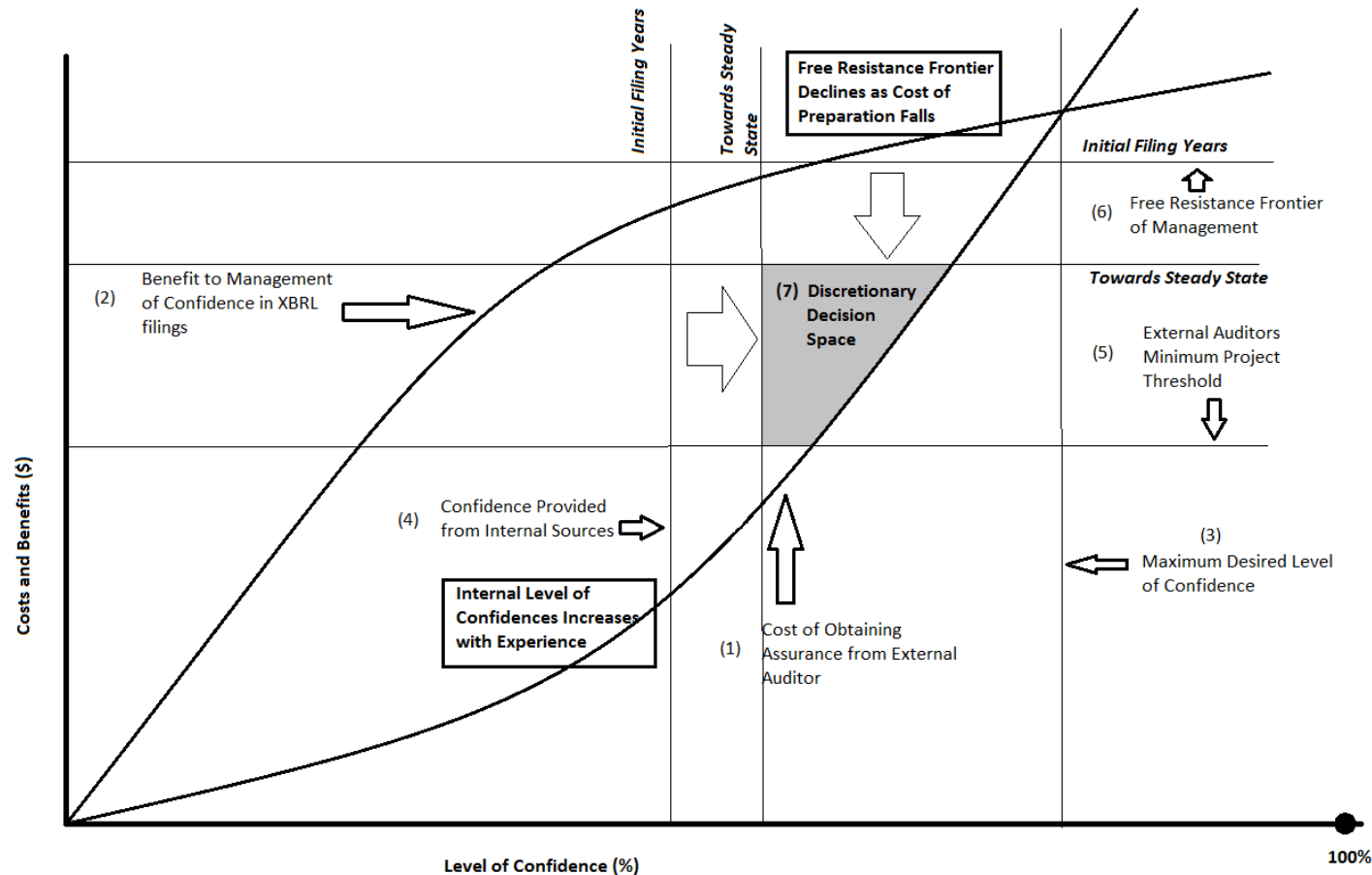
Holistic view of how managers obtain confidence on XBRL filings

- ▶ Whether to purchase external assurance services relative to other sources of confidence depends on:
 1. Benefits obtained from more confidence
 2. Confidence provided by internal sources
 3. Cost of external assurance
 4. Minimum fee acceptable to auditor
 5. Fee resistance frontier of the client determined by the external cost relative to preparation cost comparison

The external cost relative to internal cost comparison



Discretionary decision space shrinks in steady state



Opportunity for external assurance limited when it is not mandated

- ▶ The external cost relative to internal cost comparison will increasingly reduce the discretionary decision space within which the purchase of externally provided assurance for XBRL filings becomes feasible.
- ▶ This is similar to the way in which the external cost relative to preparation cost comparison works against the use of an external source of confidence in XBRL filings as the cost of preparation and the cost of external assurance of XBRL filings diverge.

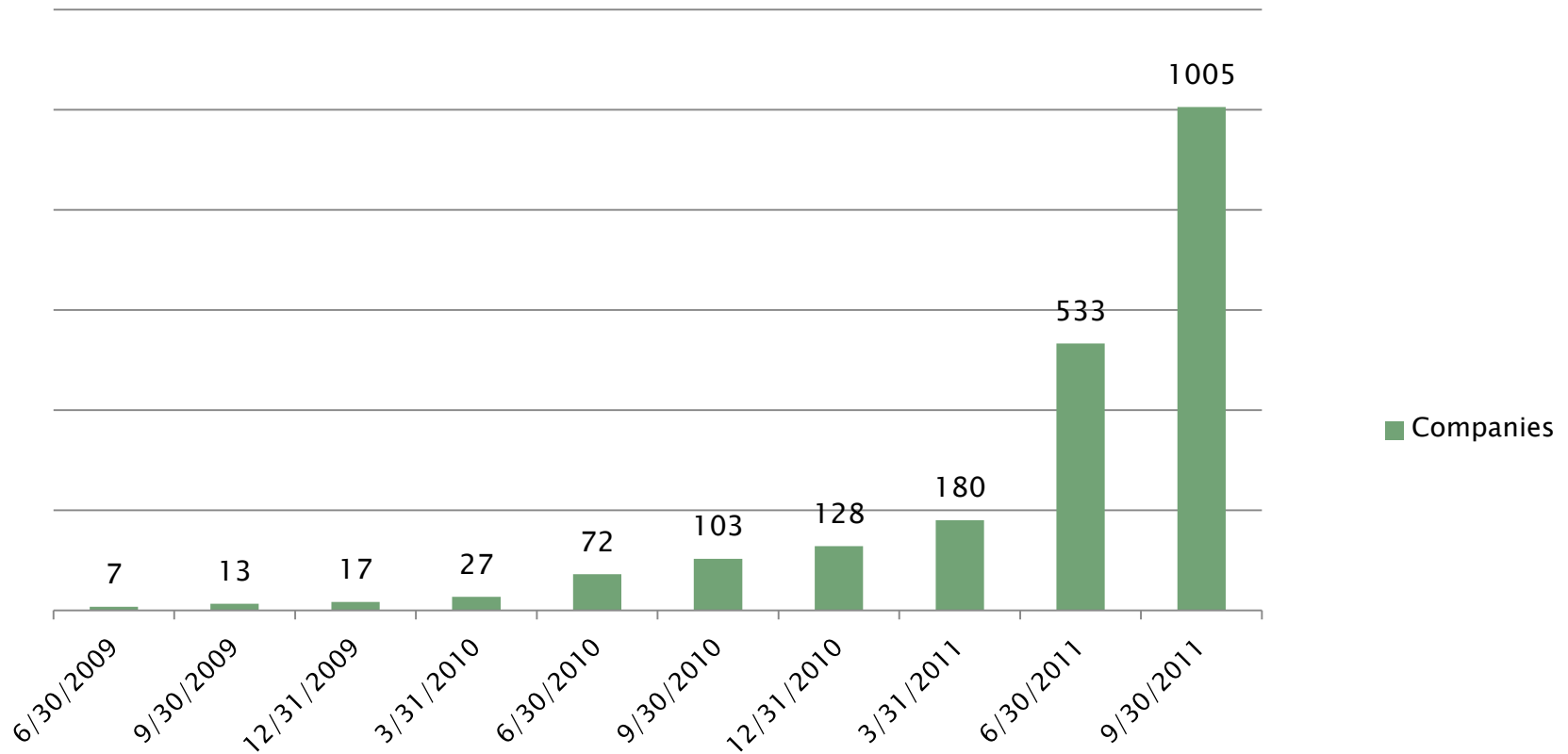
Implications of the conceptual model

- ▶ Both relative cost comparisons lead to the conclusion that demand for external assurance of XBRL filings is not guaranteed.
- ▶ External auditors will respond accordingly:
 1. Either the cost of external assurance has to actually fall, or else,
 2. The salience of that external cost in the manager's decision making process has to be reduced, so making the cost of external assurance appear relatively less significant.

Reduce relative cost of external assurance of XBRL filings

- ▶ Convert external assurance from a variable to a fixed cost by shifting assurance to the mechanism by which preparation is undertaken. This means either the company's own staff utilizing XBRL preparation software, or the outsourcing of the filing preparation and submission to a financial printer or other filing agent.
- ▶ Increasing confidence in either reduces need to assure each and every filing prepared.

Large filers gaining confidence with in-house solutions



Smaller filers can rely on certified filing agents

- ▶ Filing agents have to prove that they follow a standardized set of procedures, including, most critically, for the selection of tags and extensions.
- ▶ Providing assurance on the process used by the filing agent is analogous to obtaining ISO certification, such as ISO 9000.
- ▶ Filer can utilize regulatory system already in place: the Service Organization Controls Reports issued under SSAE No. 16.

SOC Reports as external sources of confidence in XBRL filing agents

- ▶ We envisage XBRL filing agents commissioning a SOC 1 Report: *“Report on Controls at a Service Organization Relevant to User Entities’ Internal Control over Financial Reporting—SOC 1 engagements are performed in accordance with Statement on Standards for Attestation Engagements (SSAE) 16, Reporting on Controls at a Service Organization. SOC 1 reports focus solely on controls at a service organization that are likely to be relevant to an audit of a user entity’s financial statements.”*
- ▶ Given the specific situation some aspects of SOC2 and SOC3 may be also applicable: *“SOC 2 and SOC 3 engagements address controls at the service organization that relate to operations and compliance.”*

Another strategy is to hire external auditor to validate internal process

- ▶ Filers may hire an external auditor to undertake an agreed upon procedure for the first time they file, with the emphasis not on just obtaining confidence on that year's filings, but also of using the external auditor to help improve the filer's own processes for preparing and reviewing those filings.
- ▶ Once the firm has validated its own filing processes, it obtains its required confidence internally without having to pay a yearly cost for external assurance.

Reduce perceived cost of external assurance instead of actual cost

- ▶ Auditor can attempt to roll XBRL assurance into the mandated financial statement audit to reframe the discussion:
- ▶ From: *“How much does assurance of XBRL filings cost relative to the cost of preparing those filings and/or the cost of obtaining confidence through alternative means?”*
- ▶ To: *“How much more will assurance of XBRL filings cost relative to what is already being paid in fees for the financial statement audit”*

Already see this happening with agreed upon procedures

- ▶ This is still a relative cost argument, but one that is much more favorable to the external auditor:
 1. *“With the average audit fee being approximately \$2 million, another \$25–50,000 is just another one or two percent increase in costs”.* Paul Penler of Ernst & Young
 2. *“The cost of AUP’s is very insignificant to a top 500 company already paying millions for their audit.”* Dan Roberts, past chairman of the XBRL US steering committee

Will this strategy really work?

- ▶ Success of such a strategy depends critically on whether the client sees the audit of the financial statements and the assurance of the XBRL filings as a joint product that should be combined.
- ▶ Akin to selling an extended warranty on a consumer product or new car—doesn't always work if the relative cost is too prominent.
- ▶ Harder to apply to smaller filers with their lower financial statement audit fees.

Concluding comments

- ▶ Regardless of what happens as far as mandates and assurance frameworks are concerned, the bottom line is that any XBRL assurance regime cannot function if it does not take into account the relative costs of obtaining that confidence.
- ▶ Researchers need to take relative costs into account when developing assurance frameworks and regulators have to examine how auditors will attempt to work around this constraint.