In the aftermath of the financial crisis, change seems inevitable for the audit profession. Following numerous inquiries there are currently proposals at both the European and UK levels. It is imperative that the audit profession itself responds to these challenges and engages in the debate. This timely research report investigates the views of auditors regarding change. This study is based on a questionnaire survey of auditors and interviews with auditors and regulators and investigates views on assurance on management commentary and more general views on the scope and value of the current audit.

This study finds that auditors are prepared to respond positively to investor and user concerns. However, auditor liability continues to be considered a significant obstacle. It is argued that radical reformation of assurance is required and that this should be considered, together with the need for more cohesive and accessible corporate reporting to ensure that the new audit-reporting model is more entity-specific and judgement-focused.
Can we meet the needs?

Auditor views on external assurance and management commentary

by

Ian Fraser
Jacqueline Pierpoint

University of Stirling

Published by

The Institute of Chartered Accountants of Scotland
CA House, 21 Haymarket Yards
Edinburgh EH12 5BH
CONTENTS

Foreword ................................................................. i
Acknowledgements .................................................. iii
Executive summary .................................................. v

1. INTRODUCTION ......................................................... 1
   Background ............................................................ 1
   Scope and structure of the research ......................... 4
   First stage results .................................................... 5
   Structure of report .................................................. 6

2. SETTING THE SCENE: RECENT DEVELOPMENTS ............. 9
   Corporate reporting ............................................... 10
   Audit reporting and audit quality ............................. 12
   Governance ......................................................... 16
   Summary ............................................................. 17

3. RESEARCH METHOD ................................................. 19
   Research questions ................................................ 19
   Questionnaires ..................................................... 20
   Interviews .......................................................... 22
   Analysis and discussion of results ......................... 24

4. MANAGEMENT COMMENTARY .................................. 27
   Importance of management commentary ................. 27
7. **ENHANCING AUDIT REPORTS** ................................................................. 95
   - Audit report usefulness ................................................................. 95
   - Standard audit reports ............................................................... 96
   - Inadequacies and enhancement ................................................. 98
   - Enhancing audit reports: Generic approaches ......................... 100
   - Entity-specific audit reports ..................................................... 102
   - Litigation .................................................................................... 103
   - Interpretive abilities of users ..................................................... 105
   - Technical feasibility of enhancing audit reports ...................... 107
   - Reporting by auditors or by management? ............................... 109
   - Reporting on management commentary .................................. 114
   - Summary .................................................................................. 117

8. **AUDITOR-INVESTOR DIALOGUE** ......................................................... 121
   - Enhancing auditor-investor dialogue ....................................... 122
   - Summary .................................................................................. 133

9. **REGULATORY PERSPECTIVES** .......................................................... 135
   - Management commentary ......................................................... 136
   - Audit reports ............................................................................ 139
   - Governance and liability .......................................................... 141
   - Judgement, process and regulation .......................................... 144
   - Other issues ............................................................................. 146
   - Summary .................................................................................. 147
10. Conclusions ........................................................................................................... 149
    Introduction ............................................................................................................. 149
    Management commentary ..................................................................................... 149
    Assurance on management commentary ............................................................... 150
    Process, rules and judgement .............................................................................. 152
    Audit reporting ....................................................................................................... 153
    Auditor-investor dialogue ..................................................................................... 155
    Summary, policy recommendations and further research ................................. 155

References .................................................................................................................. 159
About the Authors ..................................................................................................... 163
About SATER ............................................................................................................... 165
FOREWORD

While many causes for the financial crisis have been suggested, the United States Senate Permanent Subcommittee on Investigations issuing the Levin-Coburn Report found that “the crisis was not a natural disaster, but the result of high risk, complex financial products; undisclosed conflicts of interest; and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street”. Nevertheless, whilst the audit profession is not being blamed for the crisis, it is inevitable that the crisis has again brought to the fore questions surrounding both the scope and quality of the external audit.

Following numerous reviews and public inquiries, there are currently wide-ranging proposals for reform at both the European and UK levels, and change seems inevitable for the audit profession. It is therefore imperative that the audit profession itself responds to these challenges and engages in the debate.

This timely research report investigates auditors’ views on the importance and feasibility of external assurance on management commentary and the forms of assurance and reporting that might be applied. Auditors’ views on more general assurance issues are also explored, including views on: the robustness of the external audit process; the usefulness of current audit reports and how they might be enhanced; and other means of enhancing auditor-user communication.

This report finds that auditors are prepared to respond positively to investor and user concerns, in particular there is agreement that assurance can be extended to management commentary and that more useful audit reports and better auditor-investor communications are possible. However, auditor liability continues to be considered a significant
obstacle and there is a need also to consider the implications on the corporate governance model. The authors argue that radical reform of assurance is required and that this should be considered together with the need for more cohesive and accessible corporate reporting to ensure that the new audit-reporting model is more entity-specific and judgement-focused.

The report arising from the first stage of the project which investigated the views of users can be downloaded at www.icas.org.uk/fraser-users.

This project was funded by the Scottish Accountancy Trust for Education and Research (SATER - see page 165). The Research Committee of The Institute of Chartered Accountants of Scotland (ICAS) has also been happy to support this project. The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that the project will take forward the debate about the future of assurance. The Committee is pleased that the findings of this report were also useful to the ICAS working group, which included Ian Fraser, which was responsible for the recent ICAS publication The Future of Assurance (www.icas.org.uk/futureofassurance).

Allister Wilson
Convener, ICAS Research Committee
September 2011
Sincere thanks are due to all those who made this research possible. We would like to thank all the auditors who replied to the postal questionnaire survey and who, in many cases, took the trouble to supply extensive additional comment. We are especially thankful that so many auditors were willing to make time in their diaries to be interviewed; indeed, we were unable to interview all volunteers and we apologise to those whom we were unable to accommodate. Clearly many auditors are thoughtfully concerned about both the threats and opportunities currently facing the profession; this bodes well for its future development.

We are also grateful to the representatives of several regulatory bodies who agreed to be interviewed. For confidentiality reasons, none of the interviewees is named here but both the researchers and the ICAS Research Committee appreciate their contribution greatly.

Sincere thanks are due to several colleagues from the Accounting and Finance Division, Stirling Management School, University of Stirling – Tamer Elshandidy for ad hoc research assistance and Donna Mckendrick and Jessica Mckinley for the transcription of the interviews. Thanks are also due to William Henry for his assistance at the earlier stages of the research. The researchers would also like to thank Michelle Crickett and Angie Wilkie of the ICAS research department for their constant support and encouragement.

Finally, the Research Committee and the researchers are grateful for the financial support of the Scottish Accountancy Trust for Education and Research, without which the research would not have been possible.
The external audit, or assurance, function, in the UK and other major economies, may be set for unprecedented change, as suggested, for example, by the September 2010 EC green paper (EC, 2010) and current deliberations. There is a growing realisation, prompted by pressure from investors and other users, that assurance is not presently provided on the most appropriate things. There is a sense that auditor-shareholder relationships should be enhanced and there are concerns about audit quality, including the respective emphases placed on process and judgement. The recent financial and economic crisis has led to these issues featuring in professional, regulatory and political discourse.

This publication reports on the second stage of research focusing on several of these issues. The background is explained in detail in the reports on its first stage (Fraser et al., 2010; Fraser and Henry, 2010) but its major concerns are to investigate, first, the desirability and feasibility of providing external assurance on management commentary and, second, the usefulness of current audit reporting and means of enhancing that reporting. The first research stage investigated these and related issues from the perspective of both investors and non-investor users. The first stage results highlighted users’ demand for assurance on the ‘front-end’ of annual corporate reports, their concerns about the usefulness of audit reports, and less importantly, the robustness of the external audit process and a desire to reinforce the auditor-shareholder relationship. This second stage report identifies auditors’ views on six questions. In summary form these are:

1. How important is management commentary to users?
2. How important and feasible is external assurance on management commentary?
Executive Summary

3. What forms of assurance and reporting might be applied to management commentary?

4. How robust is the external audit process?

5. How useful are current audit reports and how might they be enhanced?

6. What other means of enhancing auditor-user communication might be adopted?

The research was conducted by means of, first, a postal questionnaire survey of audit partners and other senior auditors (124 responses, response rate 17.8%) and, second, 23 semi-structured interviews with auditors who responded to the survey. Finally, the issues were explored in interviews with four representatives of organisations with an interest in auditing regulation.

Findings

The key findings with respect to the six research questions are:

Question 1 How important is management commentary to users?

- Management commentary is perceived by auditors as important to users. This reflects the increasing complexity and opaqueness of the corporate report ‘back-end’ (ie. the financial statements). However, there are reservations about the usefulness of much existing management commentary. Some auditors perceive a need not merely for more useful management commentary but for more business-orientated corporate reporting. This is reflective of initiatives such as ICAS (2010a) but some individual views go further.
Question 2 How important and feasible is external assurance on management commentary?

• Assurance on management commentary is regarded as important; auditors are more positively disposed to this than investors. Auditors score the need for assurance on some management commentary elements as greater than investors while the converse also applies. There is no significant difference between the respective opinions of auditors and investors on the key dimension of future prospects.

• There is relatively little opposition to management commentary assurance in principle; objections are largely non-technical. There are parallels between assurance on future-orientated financial information and work already carried out, for example, in due diligence contexts. There are positive views about auditors’ ability to opine on qualitative areas, e.g. risk, not necessarily related closely to the financial statements. It is perceived that this may require the recruitment of non-financial specialists and that this might disadvantage smaller firms.

• Financial implications are not regarded as an insuperable barrier to management commentary assurance. The incremental addition to existing assurance costs envisaged is generally around 25%. Individuals from regulatory bodies who participated in the research see neither technical nor financial barriers as insuperable.

• Three non-technical issues, in particular, are perceived to be more significant obstacles. First, some auditors believe that assurance on management commentary, and particularly its more judgemental elements, would blur the distinction between management and auditor responsibilities. Second, there are concerns about how auditors could feasibly report on management commentary. There are perceived difficulties as to providing assurance in ‘true and fair’ terms; developing an acceptable reporting template, therefore, is
necessary but potentially challenging. Given calls for cohesive and ‘joined-up’ corporate reporting, however, it seems opportune to develop reporting covering assurance on both the ‘front’ and ‘back’ of the annual report. Third, auditor liability is regarded as a serious obstacle to widening the scope of assurance. These matters are related to broader concerns about the need for a more radical, useful and cohesive corporate reporting and assurance package.

**Question 3** What forms of assurance and reporting might be applied to management commentary?

- More robust forms of assurance are regarded as feasible for the less problematic elements of management commentary; for the qualitative or future-orientated elements there is a preference for process or consistency approaches. In the case of the most difficult aspects of management commentary, however, a substantial proportion of auditors still believe that some assurance is possible. The form of assurance is one of the few issues indicating clear divergence of view between Big Four and non-Big Four auditors with the former showing relative preference for process approaches.

**Question 4** How robust is the external audit process?

- Many auditors hold negative views about the impact of regulation on auditor judgement, although this is juxtaposed with appreciation of the difficulties faced by regulators. There are differing views as to the reasons for a greater emphasis on process. Assurance on management commentary, however, may both facilitate and necessitate a renewed emphasis on judgement and scepticism. Some revision of customary professional firms’ staffing and business models may be appropriate.
Question 5  How useful are current audit reports and how might they be enhanced?

- Auditors are relatively supportive of existing audit reports and are more wedded than users to generic styles where key judgements or details of the audit are invisible. Many auditors, however, believe, in principle, that they should ‘say more’ and that investors and other stakeholders should receive audit reports which are more obviously useful. There are various forms which more expansive audit reporting might take; the main possibilities are more entity-specific detail on the audit process or on key accounting and/or auditing judgements.

- Perceived obstacles to more entity specific audit reporting are similar to those in respect of management commentary assurance; especially significant are auditor liability and the potential blurring of auditor and management responsibilities. It is perceived that the latter issue may affect auditor-management relationships and governance dynamics. There is some perception that management would regard more entity-specific audit reports unfavourably although this has not been empirically tested. The most radical auditor views on reporting suggest more cohesive and business-orientated corporate reporting with, for example, auditors writing their ‘own’ management commentaries on those of management.

Question 6  What other means of enhancing auditor-user communications might be adopted?

- Audit committees may be the most acceptable and feasible way of enhancing auditor-shareholder dialogue given existing corporate governance structures. In one sense, more detailed audit reports are a straightforward means of enhancing auditor-investor relationships, although there are disadvantages as noted above. Written questions to auditors in advance of AGMs or the use of websites may be feasible conduits for dialogue although they are not generally regarded enthusiastically.
Executive Summary

Summary, policy recommendations and suggestions for further research

Auditors are prepared to respond positively to significant elements of contemporary investor and user concerns. There are few purely technical obstacles to extending assurance and auditors favour assurance on management commentary in principle. More useful audit reports and better auditor-investor communications are regarded as technically possible. An imaginative and holistic response to both management commentary and audit reporting issues might, longer term, facilitate more cohesive and ‘seamless’ reporting including not just the financial statements but key narrative disclosures with integrated assurance on both. Long-term, several factors may challenge the UK tradition of audit reporting in generic terms such as ‘true and fair’. These factors include the difficulty of opining on management commentary in ‘true and fair’ terms and a desire for more judgement-specific audit reports.

Several matters require addressing before progressing the issues. Many auditors regard auditor liability as a significant obstacle. Corporate governance implications require consideration, especially the delineation of management and auditor responsibilities, the attitudes of preparers and non-executives and the dynamics of governance generally. There is an appetite for change and concrete policy proposals need to be developed. Proposals should not be restricted to assurance but should also recognise the need for more cohesive and accessible corporate reporting. Recent ICAS initiatives (ICAS, 2010a, 2010b) provide possible responses. A new audit-reporting model should engage with all key elements of the annual report and exhibit more entity-specific and judgement-focused character.

There is a need for action on several fronts. First, the issues require exploration with preparers and non-executives. In addition to the matters covered by the research, possibilities for an integrated corporate reporting and assurance model and the implications for governance should be
considered. Second, extending the scope or reporting of assurance may depend on resolving the perennial auditor liability issue. Third, there is scope for research on investigating the process-judgement balance within auditing.

Recent financial and economic events, the conclusions of this research and other key initiatives all suggest that radical reformation of external assurance is required. The nettle must be grasped.
INTRODUCTION

This report presents the results of the second stage of research on the future of external assurance with a particular focus on management commentary. The first stage explored the perceptions of investors and other users; interested readers are referred to the full research report (Fraser et al., 2010) or the short research summary (Fraser and Henry, 2010). This second stage investigates the views of auditors, and to a lesser extent, those of regulators.

Background

External assurance is presently the subject of unprecedented reflection. Several developments and intellectual undercurrents have produced a frisson of anticipation regarding future possibilities both in terms of more valuable and user-focused assurance and of new auditor opportunities. Realising such opportunities depends partially on auditors’ ability and willingness to respond to user needs. The more important developments, relevant to the research, are outlined here.

First, narrative or non-financial statement elements of corporate reports are increasingly important to users relative to the financial statements themselves. This trend has gained momentum due to recognition that financial statements have become both overly long and too complex, even from the perspective of expert users. Users risk being overwhelmed by ever-increasing volumes of data while simultaneously lacking easily usable information. The ‘front-end’ is increasingly important and this is reflected in regulatory developments such as the Exposure Draft of the International Accounting Standards Board (IASB, 2009) on ‘Management Commentary’. A recent ICAS publication, Making Corporate Reports Readable (ICAS, 2010a), is a less
formal and more general initiative, whose objective is to facilitate more effective communication to investors and users by providing radically shorter and simpler corporate reports. It proposes that ‘it is time to enable shareholders to see the wood from the trees’ (ICAS, 2010a, p.v).

Second, the increasing importance of those elements of the corporate reporting package, traditionally regarded as peripheral, highlights whether assurance should and can be provided on such disclosures and, generally, whether assurance is currently being provided on the ‘right’ things. This is not just because the ‘front-end’ is becoming more important to users but because accounting as traditionally conceived – the ‘back-end’ – may be becoming ‘too difficult’ for auditing, at least as traditionally conceived. In this connection there is an increasing awareness of the distinction between auditing, which carries connotations of rigorous verification and, in a UK context at least, truth and fairness, and the more general concept of assurance. ‘Assurance’ may be a suitable response in situations where ‘audit’ is impossible or inappropriate. At the very least, the ‘auditability’ issue requires debate. The recent financial crisis has highlighted aspects of this issue such as an arguable over-emphasis on fair values in current accounting practice (see Woods et al., 2009) and the particular complexities inherent in the financial statements of financial institutions.

If assurance is extended to cover elements of corporate reporting other than the financial statements, this gives rise to a further issue regarding the depth of assurance which it is feasible to provide on such relatively unfamiliar material. There is little regulatory literature on advancing the boundaries of assurance into this space although relatively recent publications by The Institute of Chartered Accountants in England and Wales (ICAEW, 2008) and by ICAS (2010b) are examples of semi-official responses.

These two issues – first, the increasing importance of management commentary and similar disclosures, and, second, the associated assurance implications – constituted the initial rationale for the research
project. The assurance issue prompts further issues such as, third, the usefulness of audit reports and, fourth, the usefulness of the audit itself. If, for example, users believe that the audit process is of little value, this weakens substantially the case for extending the scope of assurance. These third and fourth issues, therefore, also formed part of the initial framework of the project.

The efficacy of audit reports and the audit process have been the subject of more general comment and discussion. Audit reports have been the subject of discussion documents or position statements by various professional or regulatory bodies including the UK Auditing Practices Board (APB), the International Auditing and Assurance Standards Board (IAASB) and the ICAEW. There is also evidence of users lobbying for changes to the statutory audit reporting model which arguably has not been reformed radically since its introduction in 1844. Audit reports continue to have a generic, rather than an entity-specific, character. There is an increasingly vocal strand of opinion which holds that audit reports need to communicate more about the audited entity rather than simply recycling material about what the auditing craft is or is not.

Debate on assurance over the ‘front-end’ highlights the issue of the robustness of the audit process, and particularly whether auditors have the skills to opine on ‘softer’ disclosures such as management commentary. There are other current issues relating to auditor competency. One is auditors’ ability to challenge corporate management on asset valuations, particularly those grounded in concepts of fair value. Similarly, the new UK Corporate Governance Code (FRC, 2010) requires more onerous corporate governance obligations of auditors by, for example, explaining their understanding of the entity’s business model.

A fifth, and increasingly visible issue, is auditor-investor dialogue generally with agendas for change from bodies such as the Global Auditor Investor Dialogue (GAID, 2009). Some investors wish to ‘reconnect’ with auditors believing that the historic auditor-investor
link requires reinstatement. This was not part of the initial research framework; however, the issue of auditor-investor communications emerged from the first stage interviews, because of the obvious link with audit reporting. This issue, therefore, was incorporated within the design of the second research stage. Considering audit reporting and auditor-investor communications leads on to general governance issues. Investors and other users clearly wish for more information but it is not always clear who should provide this, with auditors, audit committees and preparers themselves all being possible contenders. The view that audit reports should exhibit a more entity-specific and detailed character is not necessarily one which is shared by all users; an alternative perspective might argue that more information should come from the audited entity itself rather than from the auditors. It may be appropriate to consider audit committees as a possible conduit for communications with investors.

The above review indicates major implications for the future of assurance. The primary research objective is to contribute strategically to that future. The research project is being progressed concurrently with other major initiatives and aims to both contribute to, and learn from these. In this respect, the ICAS working party on the future of assurance established in the spring of 2010 is particularly significant, with its final report, The Future of Assurance, published in December 2010 (ICAS, 2010b).

Scope and structure of the research

This research addresses the major issues highlighted in the previous section. The key objectives of the two research stages together are, first, to identify the views of both users and auditors on the need for, and feasibility, of assurance on management commentary, and, second, to identify the views of the same constituencies on general assurance issues, audit reporting, auditor-user communications and the usefulness
and robustness of the audit process. In terms of the first objective, the questionnaire elicited perceptions specifically on ‘management commentary’. The interviews, however, demonstrated that, in the context of assurance additional to the financial statements, many auditors think in terms of the ‘front-end’, or in similar terms, rather than ‘management commentary’. It was appropriate, therefore, not to restrict the interview discussions and so the results and conclusions sections of this report refer to either ‘management commentary’ or the ‘front-end’ depending upon the context. It is also appropriate to highlight assurance on the ‘front-end’ in the context of the recent ICAS (2010b) proposal for there to be some assurance over the annual report as a whole. This report is concerned with the views of auditors. The opportunity has also been taken to consult representatives of several relevant regulatory bodies.

First stage results

The first stage results may be accessed in Fraser et al. (2010) or more concisely in Fraser and Henry (2010). A brief summary follows:

- Management commentary is valued by both investor and non-investor users with both constituencies believing that at least some assurance on management commentary is desirable to identify inconsistencies between narrative statements and the hard data audited currently, curb over-optimistic directors’ statements and provide more transparency. Some expert users have less need for assurance because of access to other information. Assurance on management commentary may be especially important for small investors or non-investor stakeholders.

- Users are more positively disposed towards assurance on the more ‘verifiable’ elements of management commentary such as ‘past results’ and ‘key resources, risks and indicators’ but views regarding assurance on ‘softer’ elements such as ‘future prospects’ are less positive. Some
users believe that ‘lighter touch’ assurance might be provided on such content; for example, in terms of whether or not content is ‘reasonable’ given knowledge at the time. There is a preference for applying more robust assurance approaches to more historic or quantitative elements of management commentary. Users generally have a preference for communicating management commentary assurance in the standard, rather than in an additional, audit report.

• Users, at best, are only mildly confident about the robustness of the audit process; some are decidedly unconfident. Specific concerns include the perception that audits are often process, rather than judgement, driven.

• There is consensus across all user groups that current audit reports have very limited usefulness and that audit reports should be revised by making them more entity-specific. Current initiatives, such as those of the UK Auditing Practices Board (APB, 2007), may not go far enough in this regard to satisfy users.

• Some users perceive a need for auditors to ‘reconnect with investors’ and for enhanced auditor-investor dialogue.

Structure of report

The report proceeds as follows. Chapter two provides more detail on the developing regulatory and institutional background since the publication of the first stage results. Chapter three explains the research methods. A postal questionnaire survey of partners and other senior auditors in the top 20 UK firms was followed by interviews with 23 audit partners and directors. Four interviews were also carried out with representatives of bodies with interests in audit regulation. Chapters four to eight analyse the results of both questionnaire and auditor interviews. Chapter four investigates views on the significance of management commentary itself.
Chapter five explores perceptions on the desirability and feasibility of providing management commentary assurance. Chapter six explores views on issues relevant to the robustness of the audit process, especially the respective emphases placed on process and judgement. Chapter seven deals with views on audit report usefulness and how that might be enhanced while chapter eight deals with auditor-user communication and dialogue generally. Chapter nine reports the views of the regulatory representatives. Chapter ten summarises the conclusions and makes policy recommendations and suggestions for further research.
2 Setting the Scene: Recent Developments

This chapter details the developing institutional, regulatory and academic background relevant to the second stage of the research. Current calls for a reappraisal of the external audit are discussed as it is apparent that key questions about external assurance are being asked by users. Two of these concern, first, the subject matter of assurance and, second, the manner by which that assurance is communicated to users. These two questions are:

1. What is the appropriate scope of the assurance which should be offered to users?
2. How should that assurance be communicated to users?

These questions helped define the initial parameters of the research. The two questions are not mutually exclusive; most obviously, more entity specific reporting on matters of judgement, managerial estimates and risk has an articulation with assurance on management commentary which is the obvious locus for corporate reporting on judgemental matters. A third question emerges once the first and second are considered:

3. Who should offer assurance and to whom should that assurance be conveyed?

The ‘who’ here extends beyond assurance per se, since, while it is now largely non-contentious that users have an appetite for more entity-specific information, it is not always clear whether this concerns assurance or corporate reporting. There is an argument, for example, that the apparent desire of users for more informative audit reporting
could be met by audited entities themselves supplying more information. This, therefore, has implications for the efficacy of corporate reporting itself. The ‘whom’ of the third question does not assume necessarily that enhanced assurance should be directed to shareholders but that, for example, audit committees may have a role to play as either providers or recipients. This may be inconsistent with auditing committees’ traditional role as assurance guardians. Thus the questions do not relate just to audit, or even corporate reporting, but to governance. The third question also suggests considering whether or not there are feasible channels for auditor-user communication, other than audit reports. The dynamics of auditor/user/board relationships did not form part of the original research design, but the auditor-investor dialogue issue emerged from the first stage interviews with users and so was incorporated within the second-stage research design. Thus corporate reporting, audit reporting and governance are mutually dependent. The following sections describe recent developments in each area.

**Corporate reporting**

There is a growing momentum for simpler and more accessible corporate reporting. For example, in its review of the banking crisis, The House of Commons Treasury Committee (HCTC) suggested that ‘the FSA consult on ways in which financial reporting can be improved to provide information in a more accessible way’ (HCTC, 2009, para.247). Paradoxically, however, some quasi-regulatory developments may be moving financial reporting towards greater complexity. A discussion paper (IASB, 2008) produced jointly by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) contains proposals for increased disaggregation in financial statements which, ICAS argues, may actually increase the opaqueness of IFRS-based financial reporting (ICAS, 2010a).
Nevertheless, arguments for less detail and more clarity appear in several regulatory and professional publications. Recent research (MARC, 2010) commissioned by the Global Public Policy Committee (GPPC), the forum of representatives from the six largest international accounting networks, which surveyed investors and company insiders in five European countries including the UK, suggests that ‘investors have trouble understanding financial statements due to the myriad of changes in financial reporting regulation’ (MARC, 2010, p.5). The UK Financial Reporting Council (FRC) has ‘set out to determine the causes of increasing complexity and decreasing relevance, and to develop recommendations aimed at improvement’ (FRC, 2009, p.4). The FRC has suggested that the scope for various uncoordinated responses to the recent financial and economic crisis has actually increased the likelihood of unhelpfully cluttered corporate reporting. Similarly, the US Securities and Exchange Commission (SEC) has reported (SEC, 2008) with the objective of improving and mitigating the complexity of financial reporting. In the UK, ICAS has published a discussion document (ICAS, 2010a) incorporating a blueprint for a specific form of ‘short form report’ which, it is suggested, may have the potential for ‘being used as the centrepiece of company’s results announcement and replacing the company’s annual review and summary financial statements’ (ICAS 2010a, p.viii). The recent emphasis on management commentary, and on narrative reporting generally, represents a different, although related, response to corporate reporting inadequacies.

Recent regulatory and professional discourse emphasises the mutual interdependency of corporate and audit reporting. The FRC discussion document (FRC, 2009) indicates users’ desire for better communication; whether this should come from companies themselves, audit committees or through audit reports, remains unresolved. A prominent theme in this discourse is the importance placed by users on judgement. The SEC Report (SEC, 2008) is explicit in highlighting the role of judgement in both financial reporting and auditing. ‘In recognition of the increasing
exercise of accounting and audit judgements, we recommend that the SEC and PCAOB adopt policy statements on this subject’ (SEC 2008, p.7). It is argued that this would encourage preparers and auditors to follow a disciplined process in making judgements. These sentiments reflect the expressed wishes of users, (Fraser et al., 2010) for the incorporation of more judgemental material in audit reports while highlighting the potential confusion arising from the unclear delineation of the respective responsibilities of preparers and auditors. The SEC paper (SEC, 2008), for example, does not distinguish clearly between the respective jurisdictions of auditors and preparers. The ICAS discussion paper (ICAS, 2010a) also highlights the mutual interdependencies in this area and makes specific recommendations concerning the disclosure of judgements. The ‘short form report’ recommended by ICAS ‘should make clear the significant judgements that have been made. These should reflect inter alia the content of the external auditors’ report to the audit committee’ (ICAS, 2010a, p.viii).

Summarising, there is growing recognition that the accessibility of corporate reporting requires improvement although the optimal interface between corporate and audit reporting remain indeterminate. The next section deals with recent developments in audit.

Audit reporting and audit quality

The subject and scope of audit reporting lie at the heart of this research and the first stage results (Fraser et al., 2010) indicate that users have both appetite for some assurance on management commentary and a desire for more informative and useful audit reports. These findings reflect wider public debate and have informed this second research stage.

The financial services faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) in reporting on bank audits (ICAEW, 2010) has suggested that auditors should be more involved in reporting on the front sections of annual reports and, in
particular, might report on whether ‘there are any material omissions in the information provided in the front section of reports, based upon the auditors’ knowledge of the bank they are reporting on’ (ICAEW, 2010, p. 10). This goes further than the usual interpretation of consistency (Fraser et al., 2010, p.21). It is also suggested that auditors should provide assurance on new ‘summary risk statements’. These suggestions are reflected by some opinion in the large firms in favour of auditing the ‘front of book’ where companies outline their business model and risks (Christodoulou, 2010). John Griffith Jones, Joint Chairman of KPMG Europe LLP, made similar points in a recent speech to the ICAEW (Griffith-Jones, 2010), stressing such phenomena as the declining incidence of basic accounting error and the relatively much greater importance of higher level financial, and non-financial, risks. The obvious point was made – auditors need to do more in these areas, for example, by forming a view on the risk assessments and forward-looking data included in the ‘front-end’ of annual reports. Indeed, it has been suggested that professional firms have seen a need (as well as, perhaps, an opportunity) for audit and assurance to be enhanced well before the recent financial crisis (see GPPC, 2006).

The issue of audit report content has received more attention from stakeholders than that of assurance on narratives, such as management commentary. The HCTC, in its ninth report for the 2008-9 parliamentary session, specifically on the banking crisis, argued for more ‘graduated’ going concern opinions. (HCTC, 2009, para.243) Investor views as to the desirability of reforming audit reports have been highlighted in the accountancy and business press (Christodoulou, 2009; Hinks, 2010; Sanderson 2010). In terms of responses from professional and regulatory bodies, the UK Auditing Practice Board’s 2007 discussion paper on the future of audit reports (APB, 2007) has been followed by other initiatives. A consultation report prepared for the Technical Committee of the International Organisation of Securities Commissions (IOSCO, 2009) acknowledges the questionable value of standard audit reports and
highlights different remedies without recommending specific solutions. An internal report for the International Accounting and Assurance Board (IAASB, 2009), while stating that auditors’ reports, particularly when qualified, are valued by users, has reiterated the point that users do not view standard audit report content as useful and that they would like reports to be more informative as regards both the audited entity itself and the audit work and findings.

The recent report on bank audits published by the ICAEW (2010) suggests that insufficient information is presently provided about the work underpinning audits and that financial statements should confirm that ‘key areas of judgement discussed with auditors are set out in the critical accounting estimates and judgement disclosures in the financial statements’ (ICAEW, 2010, p.3). The ICAEW report perhaps gives the impression that while audit quality, for example in relation to the exercise of judgement, is satisfactory, more needs to be done to explain audit’s value. There are shades here of often reiterated pleas about the need to reduce the audit expectation gap(s) by generic explanations about what audit does, or does not, involve. Nevertheless, audit firms themselves may be willing to move some way towards less generic audit reporting. In the speech to the ICAEW already referred to, KPMG joint chairman John Griffith-Jones mentioned the possibility of extending the audit report ‘from its current financially-orientated, binary “clean or qualified” wording...’ (Griffith-Jones, 2010). Most recently, both the IAASB (IAASB, 2011) and the US PCAOB (PCAOB, 2011) have published details of possible changes to the audit report. The IAASB and the PCAOB proposals are broadly similar to each other and explore such themes as the expanded use of emphasis of matter paragraphs, assurance on information additional to the financial statements and commentary or discussion by auditors on matters significant to users’ understanding of the financial statements or of the audit.

Regulatory and professional bodies have also been vocal, however, not merely on audit reports but on issues of audit quality and effectiveness.
In the wake of the financial crisis, these initiatives have concentrated on the financial sector and heralded by the HCTC deliberations during the 2008-09 parliamentary session. The HCTC, (HCTC, 2009), *inter-alia* questioned the usefulness of bank audits. It is interesting that the HCTC, as do some users, appear to conflate problems of audit and corporate reporting in that one of the points made about the audit process is that it results in ‘tunnel vision’ where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures’ (HCTC, 2009, para.221). Other points made by HCTC (2009) include the familiar argument that investor confidence in audit continues to be inhibited by a perceived lack of independence (2009, para.237) and the contention that (external) auditors have only limited capability to provide assurance on the risk management of banks (2009, para.225). This view contrasts with the recommendation of the ICAEW that external auditors should provide assurance on bank’s summary risk statements.

The ICAEW report on bank audits (ICAEW, 2010) is largely silent on matters of audit quality in contrast to another recent UK report (FSA & FRC 2010) on external audit and assurance within the financial sector produced jointly by the FRC and the Financial Services Authority (FSA). This report argues forthrightly that auditors need to challenge management more and that they sometimes display a ‘worrying lack of scepticism’ (FSA & FRC, 2010, p.8) in relation to management judgements. It is argued that auditors, rather than challenging judgements directly, and applying an attitude of scepticism directly to them, have sometimes tended to focus on identifying evidence to support managerial judgements and their compliance with accounting standards.

The contentions of the joint FSA and FRC study, however, have been contested robustly by auditors (see Sukhraj, 2010). The European study sponsored by the GPPC, referred to earlier, is more circumspect, and less critical of auditors, than the FSA and FRC study, but indicates that stakeholders who participated in the study would ‘like to see the audit model reconsidered to offer a less compliance driven, more
comprehensive approach that additionally offers a broader, more holistic view of the business’ (MARC, 2010, p.4).

Very recently, the House of Lords Economic Affairs Select Committee (HLEASC) has reinforced recent criticisms of auditors (HLEASC, 2011). The HLEASC has criticised some auditors for being ‘disconcertingly complacent’ and has urged the UK Office of Fair Trading to review the market dominance of the UK’s Big Four firms. More generally, the recent EC Green Paper (EC, 2010) has raised many questions about auditing and its regulation. These include: whether or not there should be compulsory rotation of audit firms, whether or not there should be an absolute ban on non-audit services and whether or not audit tendering is beneficial.

Summarising, there is a robust and ongoing public discourse concerning the subject of audit and assurance, the form of reporting by which assurance is conveyed to users and audit quality. This discourse involves the legislature, regulatory agencies, professional accountancy bodies and professional firms themselves. Support for this agenda varies; most obviously, while professional interests are relatively enthusiastic about extending the scope of assurance, or audit reporting, they are more reticent on audit quality.

**Governance**

The interface between audit and corporate governance has been less prominent in recent debates. Governance issues with relevance for audit or assurance, for example, a need for more effective auditor-shareholder dialogue, perhaps through audit committees, have, however, been highlighted by groups such as the Global Auditor Investor Dialogue (GAID, 2009).
Summary

This chapter reviews recent developments relevant to this second research stage. In summary:

- There is growing user momentum favouring both more informative audit reporting and widening the scope of the corporate disclosures which are the subject of external assurance. These views are echoed by initiatives of several public bodies and by some response by both the organised accounting profession and accounting firms.

- There are concerns about audit quality; for example, that auditors are not sufficiently sceptical or questioning of management judgements.

- There is a desire for simpler and more transparent corporate reporting.

- These issues are mutually dependent and some have corporate governance implications.
Research questions

The objective of the research was to elicit auditors' opinions on the following six questions:

1. How important is management commentary in enabling users to understand the business entity and what factors inhibit management commentary usefulness?

2. How important and feasible is it to provide external assurance on management commentary?

3. What form, extent and depth of assurance is most appropriate for management commentary and what form of reporting is most appropriate?

4. What are auditors' perceptions as to the robustness of the external audit process?

5. What are auditors' view as to the usefulness of contemporary external audit reports and what might be feasibly done to improve their usefulness?

6. What other means might be used to enhance communication between auditors and users; specifically investors?

A two-stage research approach was adopted. First, a postal questionnaire survey was sent to a sample of 695 registered auditors selected from all the top 20 ranked firms, other than the one firm which had no audit function, in the Accountancy Age survey of the top 50 UK accounting firms for 2009 (Accountancy Age, 2009). Second, 27
Semi-structured interviews were conducted. Twenty-three interviews were conducted with registered auditors who had replied to the questionnaire survey volunteering to participate in an interview and four interviews were conducted with representatives of organisations with an interest in auditing regulation.

**Questionnaires**

The questionnaire replicated, as far as possible, the instrument used to survey investors used during the first research stage (Fraser *et al.*, 2010) and consisted of seven sections. The first section consisted of two questions concerning the category of audit firm to which applicants were attached and the position of respondents within their firms. Section two consisted of one question eliciting views as to the likely emphasis on narrative information in future corporate reports. This was followed in section three by seven questions eliciting perceptions on the desirability of providing external assurance on management commentary, on what form such assurance might take and on the likely costs of different forms of assurance. Section four contained three questions exploring perceptions about the usefulness of contemporary audit reports and about how these might be enhanced while section five consisted of one question investigating views as to how auditor-investor communications might be strengthened. The penultimate section consisted of a question concerned with the impact of regulation on audit quality while the final section afforded an opportunity for respondents to provide additional comments and express willingness to participate in a follow-up interview.

Most questions required responses on a 5-point Likert scale of 1 (agree strongly/very important/very helpful/very reasonable/very useful/very feasible/very beneficial) to 5 (disagree strongly/very unimportant/very unhelpful/very unreasonable/useless/very unfeasible/very unbeneﬁcial). In addition, a ‘don’t know’ response category was included.
Survey populations and responses

The questionnaire was distributed by post \([n=695]\). The sample was selected from the on-line central register of UK statutory auditors [http://www.auditregister.org.uk/Forms/Default.aspx]. Of the sample of 695 auditors selected for survey, 425 represented the Big Four firms and 370 represented the firms with audit functions ranked 5-20 in the Accountancy Age survey for 2009. As far as possible, the sample was selected so as to include a number of offices for each firm spread over a variety of locations. The sample was spread over 12 English and Scottish cities. These included Birmingham, Edinburgh, Glasgow, Leeds and Manchester as well as London where a majority (415) of the surveyed auditors worked. Most of the sample representing both Big Four and non-Big Four firms were partners although some were directors or managers. The initial mailing resulted in 76 usable questionnaires being returned, representing a response rate of 10.9%. A reminder was sent about one month after the original mailing, resulting in a further 48 usable questionnaires being returned making the final response rate 17.8%. A PDF copy of an article (Fraser and Henry, 2009) on the first stage of the research which appeared in CA Magazine for October 2009 was included with the reminder in order to encourage responses. Of the final tally of 124 usable questionnaires, 102 were received from partners and 22 from directors or managers. Table 3.1 shows the split of respondents by firm type and by position.
Table 3.1 Responses by firm-type and position

<table>
<thead>
<tr>
<th>Respondent group</th>
<th>Number surveyed</th>
<th>Number responding</th>
<th>Response rates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Partners</td>
<td>Directors/Managers</td>
</tr>
<tr>
<td>Big Four auditors</td>
<td>425</td>
<td>63</td>
<td>14</td>
</tr>
<tr>
<td>Non-Big Four</td>
<td>370</td>
<td>39</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>695</td>
<td>102</td>
<td>22</td>
</tr>
</tbody>
</table>

Given that the sample selected for the questionnaire survey was composed of partners and other senior auditors, the response rates shown in Table 3.1 are regarded as very satisfactory. The response rate from non-Big Four is notably lower than that from Big Four auditors due to very low response rates from auditors representing certain non-Big Four firms. The response rates from auditors representing each of the Big Four firms were very similar.

Interviews

Of the 124 individuals who responded to the questionnaire, 44 individuals (35.5%) volunteered to be interviewed and this very high proportion indicates significant interest in the research. Twenty-three volunteers were selected for interview and were chosen so as to give as representative a split by firm and position as possible. Fourteen interviews were conducted with Big Four auditors (three or four for each firm); of these, 12 were with partners and 2 with directors. Nine interviews were conducted with non-Big Four auditors including two for each of the firms ranked five and six in the Accountancy Age survey for 2009. Of the nine interviews conducted with non-Big Four auditors, eight were with partners and one with a director. With the exception of one telephone interview, all interviews were conducted face-to-face. A
majority of interviewees were based in London; others were conducted in Edinburgh, Glasgow and Leeds. Table 3.2 shows the characteristics of each interviewee.

**Table 3.2 Interviewee characteristics**

<table>
<thead>
<tr>
<th>Auditor code</th>
<th>Firm size</th>
<th>Position</th>
<th>Listed experience experience</th>
<th>Industry specialism</th>
</tr>
</thead>
<tbody>
<tr>
<td>B4P1</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Financial services</td>
</tr>
<tr>
<td>B4P2</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Real estate; construction</td>
</tr>
<tr>
<td>B4P3</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Banking</td>
</tr>
<tr>
<td>B4P4</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Insurance</td>
</tr>
<tr>
<td>B4P5</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Varied; wide experience</td>
</tr>
<tr>
<td>B4P6</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Varied; wide experience</td>
</tr>
<tr>
<td>B4P7</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Banking</td>
</tr>
<tr>
<td>B4P8</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Financial services</td>
</tr>
<tr>
<td>B4P9</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Varied; wide experience</td>
</tr>
<tr>
<td>B4P10</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Varied; wide experience</td>
</tr>
<tr>
<td>B4P11</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Oil and gas</td>
</tr>
<tr>
<td>B4P12</td>
<td>Big Four</td>
<td>Partner</td>
<td>Yes</td>
<td>Oil and gas</td>
</tr>
<tr>
<td>B4D1</td>
<td>Big Four</td>
<td>Director</td>
<td>Yes</td>
<td>Varied</td>
</tr>
<tr>
<td>B4D2</td>
<td>Big Four</td>
<td>Director</td>
<td>Yes</td>
<td>Varied</td>
</tr>
<tr>
<td>NB4P1</td>
<td>Non-BF</td>
<td>Partner</td>
<td>No</td>
<td>Varied; wide experience</td>
</tr>
<tr>
<td>NB4P2</td>
<td>Non-BF</td>
<td>Partner</td>
<td>Yes</td>
<td>Varied; wide experience</td>
</tr>
<tr>
<td>NB4P3</td>
<td>Non-BF</td>
<td>Partner</td>
<td>Yes, (AIM)</td>
<td>Varied; wide experience</td>
</tr>
<tr>
<td>NB4P4</td>
<td>Non-BF</td>
<td>Partner</td>
<td>Yes</td>
<td>Varied; wide experience</td>
</tr>
<tr>
<td>NB4P5</td>
<td>Non-BF</td>
<td>Partner</td>
<td>Yes</td>
<td>Technology; food &amp; drink</td>
</tr>
<tr>
<td>NB4P6</td>
<td>Non-BF</td>
<td>Partner</td>
<td>Yes</td>
<td>Retail; technology</td>
</tr>
<tr>
<td>NB4P7</td>
<td>Non-BF</td>
<td>Partner</td>
<td>Yes</td>
<td>Technical partner</td>
</tr>
<tr>
<td>NB4P8</td>
<td>Non-BF</td>
<td>Partner</td>
<td>Yes</td>
<td>Construction</td>
</tr>
<tr>
<td>NB4D1</td>
<td>Non-BF</td>
<td>Director</td>
<td>Yes</td>
<td>Oil, gas and mining</td>
</tr>
</tbody>
</table>
The interviews were semi-structured around an agenda which was shown to the interviewees prior to the start of the interview or was, on request, e-mailed in advance. The duration of each interview was, on average, around one hour. All interviews were recorded; chapters four to six of this report include appropriate extracts from the transcripts. The four subsequent interviews conducted with regulators were informed by those already conducted with auditors.

Analysis and discussion of results

The questionnaire results, with the exception of open-ended questions, are presented in tables that show the mean scores and a measure of dispersion in responses based on the standard deviation. Table 3.3 shows the abbreviations used for the tables in chapters four to seven which present the results of the questionnaire survey.

Table 3.3 Abbreviations used in results tables

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Meaning</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>AP</td>
<td>Audit partner</td>
<td>102</td>
</tr>
<tr>
<td>AD</td>
<td>Audit director or manager</td>
<td>22</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>124</strong></td>
</tr>
<tr>
<td>M</td>
<td>Mean</td>
<td></td>
</tr>
<tr>
<td>SD</td>
<td>Standard deviation</td>
<td></td>
</tr>
</tbody>
</table>

Table 3.4 shows an approximate guide to the mean scores given in the tables.
Table 3.4 Descriptive labels as applied to mean scores

<table>
<thead>
<tr>
<th>Mean response</th>
<th>Descriptive label</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2.0</td>
<td>Strongly positive</td>
</tr>
<tr>
<td>2.0 to 2.5</td>
<td>Positive</td>
</tr>
<tr>
<td>2.5 to 2.8</td>
<td>Mildly positive</td>
</tr>
<tr>
<td>2.8 to 3.2</td>
<td>Neutral</td>
</tr>
<tr>
<td>3.2 to 3.5</td>
<td>Mildly negative</td>
</tr>
<tr>
<td>3.5 to 3.8</td>
<td>Negative</td>
</tr>
<tr>
<td>Greater than 3.8</td>
<td>Strongly negative</td>
</tr>
</tbody>
</table>

The standard deviation indicates the degree of consensus. In general, a lower standard deviation for a mean score implies a higher level of consensus. The tables present both means and standard deviations for each respondent group and for all respondents. The degree of dispersion as measured by the standard deviation may be characterised broadly as follows: $SD \leq 0.9$ (very low); $SD >0.9-1.0$ (low); $SD >1.0-1.1$ (moderate); $SD >1.1-1.2$ (high); $SD > 1.2$ (very high). The labels attached to these ranges are approximate; even levels of dispersion described as ‘low’ or ‘very low’ may include considerable variation in responses.

Significant differences, at 10%, between the respective questionnaire responses of Big Four and non-Big Four auditors were identified using a Mann-Whitney test. In the relatively few cases where identical, or substantively similar, questions were also asked in the two user surveys carried out at stage one of the research (see Fraser et al., 2010, p.40) Kruskal-Wallis tests were carried out to identify the existence of overall inter-group differences in the question responses. As a post-hoc procedure, Mann-Whitney tests, adjusted by a Bonferroni correction, were then carried out to test for significant differences at 10% between the scores given by the main groups (i.e. auditors, investors, non-investor
users) responding to each survey. All significant differences are reported in the tables in chapters four to eight.

The interview extracts discussed in chapters four to eight appear in italics. Table 3.5 shows the codes, inserted, with a numerical identifier, at the end of each interview extract to identify the category of interviewee (see also Table 3.2).

*Table 3.5 Codes used to identify category of interviewee*

<table>
<thead>
<tr>
<th>Code</th>
<th>Interviewee category</th>
</tr>
</thead>
<tbody>
<tr>
<td>B4P</td>
<td>Big Four partner</td>
</tr>
<tr>
<td>NB4P</td>
<td>Non-Big Four partner</td>
</tr>
<tr>
<td>B4D</td>
<td>Big Four director</td>
</tr>
<tr>
<td>NB4D</td>
<td>Non-Big Four director</td>
</tr>
<tr>
<td>AR</td>
<td>Audit regulator</td>
</tr>
</tbody>
</table>

All the interviews were transcribed and then analysed using the NVIVO software package for analysing qualitative data.
This chapter discusses auditor views on issues concerning narrative reporting in general and management commentary in particular. While the main focus of the second stage of the research on management commentary assurance, and related issues, it was considered appropriate to explore views on the significance of the ‘front-end’ of the corporate report in the context of corporate reporting as a whole.

**Importance of management commentary**

The questionnaire included only one question on the subject matter of this chapter. The question’s objective was to elicit perceptions as to the likely significance of narrative disclosures in future corporate reporting. The scores and standard deviations in Table 4.1 indicate a high level of consensus that future corporate reporting will increasingly incorporate narrative information.

**Table 4.1 Perceptions of significance of narrative reporting**

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Big Four</th>
<th>Non-Big Four</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
</tr>
<tr>
<td>Future corporate reporting will increasingly incorporate information of a narrative character</td>
<td>1.84</td>
<td>0.69</td>
<td>1.77</td>
</tr>
</tbody>
</table>

**Notes:**
No significant differences between mean scores awarded by Big Four and non-Big Four auditors.

**Scale:** 1=Agree strongly   2=Agree   3=Neutral   4=Disagree   5=Disagree strongly
Investors were asked the same question at the first research stage. Comparing the results for investors and auditors indicates that while both believe strongly that narrative disclosures will increasingly feature in corporate reporting, auditors’ views (M 1.84, SD 0.69) are significantly more positive (at 1%) than investors’ (M 2.33, SD 0.76).

While the questionnaire only contained one question specifically on management commentary, the interviews explored auditors’ views on the issues in much more depth and revealed a rich variety of opinion. Most obviously, the results of the questionnaire survey were reinforced in that the great majority of interviewees held strongly positive views about the significance of narrative reporting, specifically management commentary. The fundamental message, exemplified in the following three interview extracts, was that management commentary was an important resource and its significance to investors was only likely to increase.

*There are lots of businesses where it is actually quite complex to get underneath what they really do. How do you convey that in a set of financials? Some analysts just boil it down to what’s the return on equity, what’s the volatility – and you can do that without 150 pages of notes – but I think management commentary can add a lot to understanding what the business is really doing.* (B4P4)

*I think the management commentary is very important because I think it gives the reader of the accounts a flavour of where the company is going, what it has achieved and what its strategy is. I think the management commentary is very, very important in terms of how it’s going to develop going forward with probably a lot more emphasis on risks even than there is now. There is also likely to be a lot more emphasis on environmental and sustainability type issues. To some extent we’re talking about the size of the company, in terms of how much emphasis there will be on these areas... but I imagine that, generally for a shareholder, reading the accounts, reading the ‘front-end’, as we would say, is very important.* (B4D2)
In terms of the future, I can only see it becoming more rather than less significant for a variety of reasons including increasing business complexity and an increased desire on the part of investors and other interested parties to obtain insights into more aspects of a company’s activities. (B4P10)

The above interview extracts bring out the incremental contribution which management commentary can make to understanding dimensions of the business which are not addressed adequately, if at all, by the financial statements themselves. An alternative perspective is that of the significant number of interviewees who pinpointed the complexity or opaqueness of (IFRS based) financial statements, or simply that businesses were becoming more complex. As a result, the financial statements were becoming less accessible even for expert users.

I think financial statements in general have become harder to understand and I think in part that simply reflects that... businesses themselves are more difficult to understand. However you see comments in the press about the fact that the only people that understand IFRS are David Tweedie and perhaps a few others who live in an ivory tower and the debate continues. So if the figures at the back of the financial statements, the primary statements and notes, are difficult to understand, then commentary is one way to improve that. (B4P5)

One Big-Four auditor, with partner-level experience at the very largest FTSE companies, explained how the management commentary might serve users in identifying the accounting information which was really useful to them:

I think management commentary has always been important, but it’s becoming more so as readers of the accounts find it more
difficult to understand the financials. So, getting to the heart of the business through the management commentary and using that as the link into what the real performance of the business is and where the business is going is important. I’m not sure that the average shareholder will spend as much time at the ‘back-end’ of the accounts as maybe was the case 10 years ago. In fact, if you look at the way in which the major oil companies announce their results to the business world when they produce them on a quarterly basis you’ll see that quite often they are on a basis which isn’t IFRS, they’re on a basis that the analysts prefer. One area in particular analysts get confused around is the whole issue around hedge accounting and the like, which is obviously prevalent in the industry for a number of reasons and so the companies will produce information on one basis, which they say is the basis by which they run the business and then they’ll show the reconciliation back to what actually ends up in the accounts when they’re published. So, I think there are certain parts of IFRS, which are probably from an accounting perspective theoretically correct, but actually I’m not sure they’re giving the analysts the right information. So, you’ve got maybe a gap there between how analysts want to look at the numbers to plug into their models versus what the accounting standards board says is the right way to do it, but a lot of that gets swept up in the MD&A. There are explanations up front and these are looked at quite closely. (B4P12)

It might be noted that in referring to the ‘average’ shareholder in the previous extract, the partner meant institutional shareholders. A non-Big Four partner, who worked mainly with smaller listed, or larger private, companies communicated largely the same message from the point of view of the private shareholder.
The complexities of IFRS have meant that in a number of cases the actual financial reporting and accounting treatment of certain things could be viewed as being non commercial and we get quite a lot of pushback from clients on certain accounting standards. Comments such as ‘no one understands the ‘back-end’ of a set of financial statements anymore’ puts more emphasis on the ‘front-end’ narrative explaining the performance of the business in a language that your shareholder or investor would understand. I think the other thing that has increased the importance of the ‘front-end’ over the last 18 months is the state of the economy because a lot of businesses have been using that narrative to reassure investors. (NB4P8)

In terms of management commentary’s importance in particular industry contexts, one Big-Four banking partner highlighted the impact of the recent financial crisis:

...the financial statements that are produced for banks under IFRS are huge in terms of the extended numerical disclosures, the standards are incredibly complex and the management commentary is important to, firstly, distil a lot of data into information and, secondly, to represent to users of the financial statements a robust understanding of the management team. The last 18 months has done nothing but reinforce the importance of rich and insightful management commentary because if we had had that investors would have been better placed to make decisions. (B4P7)

Thus effective management commentary may compensate for the complexity of IFRS or of businesses themselves. However, a Big-Four partner specialising in banking emphasised that reporting on complex businesses was complex.
...businesses are complex and you can’t simplify complex businesses... on the face of it you might think the Big Four banks in the UK are actually very similar, but in actual fact they’re quite different and the only way you can get that difference is digging into the detail of what businesses they’re in and what assets they’ve got on their balance sheet and different types of credit risk that they might be exposed to... So, on one hand investors are trying to say ‘yes I want it simpler so I can make my assessment between all of the banks’, but the reality is the world is not that simple and it’s far more complex... I think if someone wants a simple report to have a basic understanding that’s fine but then people need to recognise you can’t use that sort of information to make judgements on whether you should be investing in A or B. (B4P3)

Thus management commentary may not be a panacea for the complex reporting necessary for certain businesses although one non-Big Four director suggested management commentary particularly represented a resource for smaller investors who did not have the privileged access enjoyed by the large institutions.

For me, the front section is incredibly important to a small private investor. I don’t think it is as important for the large institutional investors, because I think they have different access to information. (NB4D1)

One of the most interesting views was that of a Big Four partner who believed that management commentary was the vital part of the annual reporting package and what investors were really interested in. Nevertheless he viewed the commentary, and indeed the whole current reporting package, as inadequate and in need of reform.
I think the management commentary is important and is gaining in importance as accounts become less and less understandable and far too voluminous. I like to look at the reporting package as a business report which needs to tell a story and I think management commentary needs to tell a story about what management's views are on what has happened in the past and what their views are about the prospects for the future. I think that is what investors are mainly interested in... They are especially interested in management's assessment of the prospects of the company for the future. [Effective management commentary] is the only way you are going to bring reporting back to a tool for market communication... Ideally what you want is a much more elaborate assessment of the future by management but it is not going to happen without the liability regime for directors changing and you are never going to get the auditors commenting on it until their liability regime changes. (B4P11)

Thus this auditor visualised not so much a reformed financial reporting system but one which focused on business reporting, avoiding ‘boilerplate’ and which, therefore, also had implications for audit. This view reflects a previous ICAS publication (Beattie, 1999) which explored the possibilities for more business-orientated reporting.

The corporate report as it is today is irrelevant. I don’t think that management commentary is really adequate. My model for financial reporting would be something very different to what we have at the moment. It would be more simplified, much more disaggregated... I don’t have a vision of business reporting which looks like the status quo plus a new management commentary; I see the whole package as being completely different... No matter what you prescribe you will always sink to the lowest common denominator, you will always have some boilerplate. So I think
you have to look at it holistically in terms of content, the assurances given and the role of the auditor. You are then giving the auditor a much more pro-active role in ensuring full and fair commentary that takes you out of boiler plate. (B4P11)

This vision of corporate business reporting by a partner working with the very largest size of company was echoed by a partner from one of the smaller firms surveyed whose experience was with companies at the other end of the spectrum.

The ‘back-end’ of the accounts contains an awful lot of so called factual information, much of which is incredibly complicated. I don’t know if there is a half-way house on this... something to give a real feel for how the business is going and how the different sectors are doing... I think business reporting [rather than financial reporting] is much more interesting and much more useful. (NB4P3)

Auditors from smaller firms varied more in their views reflecting their generally smaller clients. One such director, however, while recognising that management commentary was important, stated that it was often difficult to get her clients to adopt the same perspective.

...we have many AIM listed companies and for a lot of them it is a constant struggle to get them to realise how important it actually is. Some see as just another compliance box to tick; you’ve got to write a couple of pages, you’ve got to include various things and they’ll just do it because they’ve got to... the challenge is actually getting them, in some cases, to realise the value of this and the fact, to a certain extent, that it’s a marketing exercise for them to tell the story of the financial statements to their investors. (NB4D1)
A non-Big Four partner juxtaposed the reluctance of some of his clients to disclose with his own reservations.

There is also a great reluctance on the part of management sometimes to disclose the information which the ‘front-end’ requires... There is this concern that it is giving information to competitors. ...as a result I suspect in some places this leads to the ‘front-end’ being less comprehensive than it should be. I must say my own view is that... the information given in them is I think over the top. (NB4P3)

Summarising, the interviews indicate a generally held view that management commentary is important and would become more so. It was evident that many interviewees had strong views on management commentary and had thought deeply about the issues. Some key content elements, notably risk, were highlighted, as were the limitations of reporting on such areas; for example, the impossibility of covering all risk eventualities. Many of the views expressed on the importance of management commentary reflect semi-official literature and initiatives on corporate reporting.

Limitations of management commentary

The previous section highlighted how the generally positive sentiment in favour of management commentary was tempered in at least one case by the suggestion that existing management commentaries were inadequate. Other perceived shortcomings, including boilerplate wording, were also highlighted although their volume was relatively limited when set against the amount of positive comment. Other cautionary notes sounded by individuals included the point that not too much emphasis should be placed on management commentary alone since annual corporate reports are themselves only part of a continuum of communication which included, for example, press releases, analyst
presentations and one-to-one meetings. One non-Big Four partner highlighted that there was a danger of key information being obscured by a plethora of narrative.

...certainly in my experience you read a ‘front-end’ now... and these things can run to 40-50 pages... where are the key messages in there? Are they just hidden in a huge volume of information some of which is being driven by the requirements for people to talk about KPIs?... I think some people view that as just ‘we know how we run our business but you are telling us I have to write down four or five KPIs so we will write that in addition to what we always reported four or five years ago’ so you do end up with a bit of duplication and maybe a lack of focus. (NB4P8)

While no interviewees believed that management commentary was not important to some extent, the nearest to an absolute non-believer was probably the Big-Four partner who admitted:

I suppose the question has to be ‘who is it really being provided for?... if it is being provided for a small community of investment analysts then that is fine because then you can give them information and they will analyse it. But in terms of being able to communicate the business – its performance, its market and its risks – I still don’t think we do a fantastic job. I think a lot of what I see is as confusing as it is enlightening. The truth is that generally I don’t think the annual report and accounts these days is used by most companies as a great way of communication. I think it is something they have to do and I suspect if you go to analyst presentations there will be occasions when you will be listening to the presentation and then you will look at the accounts and you will think are we talking about the same thing here or not? Maybe in a honest presentation you have a defined and powerful audience in front of you and so maybe you need to get the nice
clear crisp messages that I think sometimes are well delivered in those into a more widely circulated public document because I think that frankly some shareholders who are fortunate enough to go to those things get better information about what is going on than the man on the street. (B4P5)

The reference to the ‘man in the street’ encapsulated smaller institutional shareholders as well as the more literal meaning. There are a number of interesting opinions expressed here. There is the argument that much management commentary lacks focus in terms of content and intent. There is the suggestion of a disconnect between annual report content (whether inclusive of management commentary or not) and that of analyst presentations. There is the suggestion, often not acknowledged publicly, that there may not always be a level playing-field in terms of the dissemination of corporate information despite regulations to the contrary and that there may be a role for effective management commentary in alleviating this. Thus while this interviewee was one of the apparently most negative in terms of the present management commentary he did envisage its role could be more positive.

**Regulation of management commentary**

The consensus of opinion on the regulation of management commentary, for example by the International Accounting Standards Board, was in favour of a light-touch approach.

*I think the danger of giving a template is that you will get a template back so companies will comply but perhaps not explain or shed any light on what they are doing. So my personal preference would be to allow directors to come up with their own format and I think certain topics should either be prescribed, or headings prescribed.* (B4P4)
One of the criticisms that I hear at the moment from regulators and from certain parts of the analyst community is that even now some of it’s [i.e. management commentary] a little bit too formulaic and boilerplate and therefore what real value can anybody take out of it. So, I think it clearly has to be drafted in a way that’s informative, factually correct of course and can be linked to the financial performance of the company, but I think it’s tricky because are you looking for conformity or are you actually looking for boards to be giving the information that’s really useful to the investor? (B4P12)

One senior Big-Four partner argued for effectively no regulation.

My natural instinct would be to give them a free hand... A lot of regulation is put in to inhibit the most extreme behaviour of directors, or individuals, and actually in general terms I don’t think it inhibits those that want to be at the far end of the spectrum but just ends up inhibiting those who are actually trying to do their best. (B4P6)

The generally minimalist approach to regulation which emerged is interesting given that auditors might perhaps have been expected to exhibit more regulation-centric attitudes since regulating content might ease assurance difficulties. One non-Big Four partner, however, rationalised his view that management commentary content required regulation due to the assurance issue. Assurance could realistically be provided on quantitative data, but not on qualitative, and there was therefore a need to distinguish between the two clearly.

I think that the biggest difficulty is that the structure of narrative reporting is too raw. It allows quantitative and qualitative information to be delivered in the same section of the report. (NB4P5)
Regulation of management commentary itself required to address the quantitative-qualitative dichotomy data ‘if there is a general agreement that assurance needs to be provided’. There was, however, no sense that this view was general. Assurance is dealt with in the following chapter.

Summary

This chapter has explored auditor views on the significance of corporate narrative reporting, specifically narrative commentary. The main findings are:

- Senior auditors, both Big-Four and non-Big Four, generally agree that narrative reporting is only likely to increase as an element of corporate reporting believing that management commentary is a resource for users and that its significance would increase in the future. ‘Front-end’ reporting is generally seen as significant. Non-Big Four auditors hold more varied views on management commentary’s significance, reflecting their generally smaller clients.

- The importance of ‘front-end’ reporting is rationalised from various perspectives including a need for more accessible reporting because of the perceived complexities or opaqueness of IFRS-based financial reporting. This is perceived as relevant to both institutional and private investors. Particular industries, notably financial services, were pinpointed here although this was largely a reflection of the industries in which interviewees specialised. At the same time, it was emphasised that some businesses, and therefore the related reporting, were necessarily complex.

- Some opinion holds that more holistic corporate reporting is required with a focus on ‘business’ rather than merely the ‘financials’. This was linked by some interviewees to the limited and ‘boilerplate’
nature of existing disclosures; ‘boilerplate’ reporting was also a more general concern. It is consistent with this attitude that most auditors favoured ‘light-touch’ regulation of management commentary content and structure.

- Although this chapter is not primarily concerned with assurance, it was striking how deeply auditors had thought about the issues. Many senior auditors are concerned not just about audit but also about the efficacy of future corporate reporting generally.
This chapter explores views on the desirability and feasibility of external assurance on management commentary. This is followed by an exploration of the depth, scope and form of the assurance that might be provided. The chapter includes a discussion of the problems which assurance on particular elements of management commentary, for example, risks or forecasted information, might present. Audit liability issues and the cost implications are also discussed.

**Assurance on management commentary**

The questionnaire included several questions which aimed to identify auditors’ views as to the provision of external assurance on management commentary. The primary question dealt with external assurance on management commentary overall and on several content elements, based on the IASB exposure draft (IASB, 2009, paras.24-29), which might be expected to feature in most management commentaries. The results are shown in Table 5.1. At the first stage of the research both investors and non-investor users were also asked this question (see Fraser et al., 2010, chapter five). Comparing the results for auditors and the key investor constituency indicates that both groups hold broadly comparable and positive views on the fundamental assurance issue; if anything, auditors’ attitudes are more positive. Although this was not apparent from either the questionnaire responses or the interviews, auditors’ support for external assurance might reflect a degree of self-interest since it creates another market for their services. This could help explain why their views are more positive than those of investors.
All statistically significant differences (p< .1) between the mean scores awarded by auditors, investors and non-investor users are shown in Table 5.1.

**Table 5.1 Importance of the assurance of an external audit on management commentary**

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Big Four</th>
<th>Non-Big Four</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
</tr>
<tr>
<td>Management commentary overall</td>
<td>2.12</td>
<td>0.71</td>
<td>2.09</td>
</tr>
<tr>
<td>Nature of business</td>
<td>3.15</td>
<td>0.97</td>
<td>3.21</td>
</tr>
<tr>
<td>Objectives and strategies</td>
<td>3.10</td>
<td>1.02</td>
<td>3.18</td>
</tr>
<tr>
<td>Key resources, risks and relationships</td>
<td>2.40</td>
<td>1.00</td>
<td>2.43</td>
</tr>
<tr>
<td>Past results</td>
<td>1.66</td>
<td>0.69</td>
<td>1.60</td>
</tr>
<tr>
<td>Future prospects</td>
<td>2.68</td>
<td>1.11</td>
<td>2.69</td>
</tr>
<tr>
<td>Performance measures and indicators</td>
<td>1.90</td>
<td>0.75</td>
<td>1.79</td>
</tr>
</tbody>
</table>

Notes:
1. Significant difference at 5% between mean scores awarded by auditors and those awarded by investors in stage 1 of the research project (auditors score more highly than investors).
2. Significant difference at 10% between mean scores awarded by auditors and those awarded by non-investor users in stage 1 of the research project (non-investor users score more highly than auditors).
3. Significant difference at 5% between mean scores awarded by auditors and those awarded by non-investor users in stage 1 of the research project (non-investor users score more highly than auditors).
4. No significant differences at 10% between mean scores awarded by auditors and those awarded by either investors or non-investor users in stage 1 of the research project.
5. Significant difference at 1% between mean scores awarded by auditors and those awarded by investors in stage 1 of the research project (auditors score more highly than investors).
6. Significant difference at 1% between mean scores awarded by auditors and those awarded by non-investor users in stage 1 of the research project (auditors score more highly than non-investor users).
7. There are no significant differences between the mean scores awarded by Big Four and non-Big Four auditors.

Scale: 1=Very important 2=Important 3=Neutral 4=Unimportant 5=Very unimportant
The results indicate that auditors generally believe that it is important to provide assurance on management commentary overall. There is a high level of consensus on this general question with no significant difference in the respective responses given by Big Four and non-Big Four auditors. Comparing the results of the auditor and investor surveys indicates that auditors scored the desirability of assurance on management commentary significantly higher (at 5%) than did both investors and non-investors (means: auditors 2.12, investors 2.56, non-investors 2.18) and exhibited a higher degree of consensus (standard deviations: auditors 0.71, investors 1.16, non-investors 1.07). Eighty-two percent of auditors (investors, 56%; non-investors, 70%) responding signalled the assurance of an external audit on management commentary was important or very important. Only an extremely small number of responding auditors indicated that assurance was unimportant or very unimportant.

Table 5.1 indicates that both Big Four and non-Big Four auditors scored the importance of assurance extremely highly for the more straightforward and less contentious content elements – past results and performance measures and indicators. Auditors appear largely neutral, perhaps predictably, regarding assurance on the (arguably) less important content elements of the nature of the business and objectives and strategies. From an assurance perspective, the most problematic ‘content element’ highlighted by the question is perhaps future prospects. This was scored more highly (mean 2.68) by auditors than by investors (mean 2.82). While the interviews revealed that many auditors had reservations and caveats regarding assurance on such content, approximately 50% of auditors responding to the questionnaire scored assurance on future prospects as very important or important with 33% neutral. Thus a very significant percentage of auditors appear to believe that assurance is important on this potentially contentious element of management commentary.
The primary question about assurance was followed by two questions which asked auditors for their views as to whether or not three different forms of assurance (audit of content, audit of process and audit of consistency) were technically feasible for, first, information classified by whether or not it was historic (forward-looking), quantitative (qualitative) and financial (non-financial) and, second, the same content elements which featured in the initial question on assurance. Each of these questions assumed the applicability of existing audit methodologies and asked respondents to ignore cost considerations. The definitions of the three possible forms of assurance proposed are shown in Figure 5.1.

**Figure 5.1 Definitions of three possible forms of assurance**

- **Audit of content**: the content of management commentary is truly and fairly stated and is understandable, relevant, supportable, balanced and comparable over time.

- **Audit of process**: the process followed by the company in producing management commentary is designed to ensure that its content is truly and fairly stated and is understandable, relevant, supportable, balanced and comparable over time.

- **Audit of consistency**: the content of management commentary is consistent with the content of the financial statements and with the law.

The basis of these definitions is explained in Fraser *et al.* (2010, page 21). Other definitions are possible; most especially for consistency and this is discussed elsewhere in this report. The results for the two questions on different forms of assurance are shown in Tables 5.2 and 5.3. These tables show percentages of respondents believing that assurance was ‘feasible’ or ‘unfeasible’ for each of the cases highlighted in the questions.
Table 5.2  Forms of assurance considered technically feasible for management commentary information with varying characteristics

Panel A: Historical information

<table>
<thead>
<tr>
<th>Audit of:</th>
<th>Feasibility</th>
<th>Total (%)</th>
<th>Big Four (%)</th>
<th>Non-Big Four (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Content</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Historical quantitative financial information (e.g. sales)</td>
<td>Feasible</td>
<td>98</td>
<td>98</td>
<td>97</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>2</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Process</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feasible</td>
<td>98</td>
<td>98</td>
<td>97</td>
<td></td>
</tr>
<tr>
<td>Unfeasible</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Consistency</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feasible</td>
<td>98</td>
<td>98</td>
<td>97</td>
<td></td>
</tr>
<tr>
<td>Unfeasible</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Historical quantitative non-financial information (e.g. environmental emissions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feasible</td>
<td>72</td>
<td>82</td>
<td>58</td>
<td></td>
</tr>
<tr>
<td>Unfeasible</td>
<td>28</td>
<td>18</td>
<td>42</td>
<td></td>
</tr>
<tr>
<td>Process</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feasible</td>
<td>86</td>
<td>95</td>
<td>71</td>
<td></td>
</tr>
<tr>
<td>Unfeasible</td>
<td>14</td>
<td>5</td>
<td>29</td>
<td></td>
</tr>
<tr>
<td>Consistency</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feasible</td>
<td>84</td>
<td>90</td>
<td>74</td>
<td></td>
</tr>
<tr>
<td>Unfeasible</td>
<td>16</td>
<td>10</td>
<td>26</td>
<td></td>
</tr>
<tr>
<td>Historical qualitative information</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feasible</td>
<td>27</td>
<td>26</td>
<td>29</td>
<td></td>
</tr>
<tr>
<td>Unfeasible</td>
<td>73</td>
<td>74</td>
<td>71</td>
<td></td>
</tr>
<tr>
<td>Process</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feasible</td>
<td>60</td>
<td>67</td>
<td>49</td>
<td></td>
</tr>
<tr>
<td>Unfeasible</td>
<td>40</td>
<td>33</td>
<td>51</td>
<td></td>
</tr>
<tr>
<td>Consistency</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feasible</td>
<td>65</td>
<td>60</td>
<td>74</td>
<td></td>
</tr>
<tr>
<td>Unfeasible</td>
<td>35</td>
<td>40</td>
<td>26</td>
<td></td>
</tr>
</tbody>
</table>

Note: All data expressed as percentages of Total/Big Four/non-Big Four respondents.
### Table 5.2 Forms of assurance considered technically feasible for management commentary information with varying characteristics (Cont.)

**Panel B: Forward-looking information**

<table>
<thead>
<tr>
<th>Audit of:</th>
<th>Feasibility</th>
<th>Total (%)</th>
<th>Big Four (%)</th>
<th>Non-Big Four (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Forward-looking quantitative financial information (e.g. future sales)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td>Feasible</td>
<td>27</td>
<td>24</td>
<td>32</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>73</td>
<td>76</td>
<td>68</td>
</tr>
<tr>
<td>Process</td>
<td>Feasible</td>
<td>76</td>
<td>81</td>
<td>68</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>24</td>
<td>19</td>
<td>32</td>
</tr>
<tr>
<td>Consistency</td>
<td>Feasible</td>
<td>70</td>
<td>71</td>
<td>68</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>30</td>
<td>29</td>
<td>32</td>
</tr>
<tr>
<td><strong>Forward-looking quantitative non-financial information (e.g. targets for emissions)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td>Feasible</td>
<td>23</td>
<td>28</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>77</td>
<td>72</td>
<td>83</td>
</tr>
<tr>
<td>Process</td>
<td>Feasible</td>
<td>67</td>
<td>76</td>
<td>53</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>33</td>
<td>24</td>
<td>47</td>
</tr>
<tr>
<td>Consistency</td>
<td>Feasible</td>
<td>59</td>
<td>64</td>
<td>51</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>41</td>
<td>36</td>
<td>49</td>
</tr>
<tr>
<td><strong>Forward-looking qualitative information</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td>Feasible</td>
<td>14</td>
<td>13</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>86</td>
<td>87</td>
<td>81</td>
</tr>
<tr>
<td>Process</td>
<td>Feasible</td>
<td>48</td>
<td>53</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>52</td>
<td>47</td>
<td>60</td>
</tr>
<tr>
<td>Consistency</td>
<td>Feasible</td>
<td>44</td>
<td>46</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>56</td>
<td>54</td>
<td>60</td>
</tr>
</tbody>
</table>

*Note: All data expressed as percentages of Total/Big Four/non-Big Four respondents.*

Table 5.2 shows that, for historical information, virtually all auditors, both Big Four and non-Big Four, envisage no problems applying any form of assurance to quantitative financial information.
As far as historical quantitative non-financial information is concerned, a clear majority of auditors from each firm category again believe that the application of any form of assurance is possible. However, a Big Four/non-Big Four dichotomy is apparent, with Big Four auditors notably more positive about the feasibility of assurance on this category of information. Eighty-two percent of Big Four auditors believe that assurance over content is possible for such information while only 55% of non-Big Four auditors do so. Such differences may reflect the relative ease of access to specialist resources available to each category of firm and this issue was highlighted by some non-Big Four interviewees.

As far as historical qualitative information is concerned, a significant majority of auditors believe that assurance over both consistency and process is possible but only about 25% of auditors believe so for assurance over content. There is no significant difference by firm size for this result. Big Four auditors, however, are much more positive than non-Big Four in respect of assurance over process for historical information of both quantitative non-financial and qualitative character. This result may reflect a greater degree of familiarity on the part of Big Four auditors with systems-based assurance. Thus 67% of Big Four auditors believe that assurance over process is possible for historical qualitative information while only about 50% of non-Big Four auditors do so.

There are generally much less positive attitudes regarding assurance on forward-looking information. In the case of the least problematic sub-category, quantitative financial information, clear majorities of both Big Four and non-Big Four auditors believe that assurance over both process and consistency are possible but only about 25% of auditors believe that content assurance is feasible. Nevertheless, this represents a substantial minority of auditors. A preference for consistency or process-based assurance is still more apparent with the more problematic categories of forward-looking information. Auditors are least positive about assurance in respect of forward-looking qualitative information with only small minorities of both Big Four (13%) and non-Big Four (15%) auditors believing that content assurance is feasible. However approximately
50% of Big Four auditors and 40% of non-Big Four auditors believe in each case that a process or consistency approach is feasible.

These results are reinforced by those for the question, which elicited perceptions about the feasibility of the three forms of assurance as regards the highlighted ‘content elements’ of the IASB exposure draft on management commentary (Table 5.3).

Table 5.3 Forms of assurance considered technically feasible for different management commentary content elements

<table>
<thead>
<tr>
<th>Audit of:</th>
<th>Feasibility</th>
<th>Total (%)</th>
<th>Big Four (%)</th>
<th>Non-Big Four (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Nature of business</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td>Feasible</td>
<td>80</td>
<td>78</td>
<td>87</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>20</td>
<td>22</td>
<td>13</td>
</tr>
<tr>
<td>Process</td>
<td>Feasible</td>
<td>85</td>
<td>84</td>
<td>87</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>15</td>
<td>16</td>
<td>13</td>
</tr>
<tr>
<td>Consistency</td>
<td>Feasible</td>
<td>92</td>
<td>88</td>
<td>98</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>8</td>
<td>12</td>
<td>2</td>
</tr>
<tr>
<td><strong>Objectives and strategies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td>Feasible</td>
<td>46</td>
<td>46</td>
<td>46</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>54</td>
<td>54</td>
<td>54</td>
</tr>
<tr>
<td>Process</td>
<td>Feasible</td>
<td>77</td>
<td>79</td>
<td>74</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>23</td>
<td>21</td>
<td>26</td>
</tr>
<tr>
<td>Consistency</td>
<td>Feasible</td>
<td>73</td>
<td>72</td>
<td>74</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>27</td>
<td>28</td>
<td>26</td>
</tr>
<tr>
<td><strong>Key resources, risks and relationships</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td>Feasible</td>
<td>55</td>
<td>55</td>
<td>55</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>45</td>
<td>45</td>
<td>45</td>
</tr>
<tr>
<td>Process</td>
<td>Feasible</td>
<td>81</td>
<td>82</td>
<td>81</td>
</tr>
<tr>
<td></td>
<td>Unfeasible</td>
<td>19</td>
<td>18</td>
<td>19</td>
</tr>
</tbody>
</table>
Table 5.3  Forms of assurance considered technically feasible for different management commentary content elements (Cont.)

<table>
<thead>
<tr>
<th>Audit of:</th>
<th>Feasibility</th>
<th>Total (%)</th>
<th>Big Four (%)</th>
<th>Non-Big Four (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consistency</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Feasible</td>
<td></td>
<td>80</td>
<td>84</td>
<td>74</td>
</tr>
<tr>
<td>Unfeasible</td>
<td></td>
<td>20</td>
<td>16</td>
<td>26</td>
</tr>
<tr>
<td>Past results</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td></td>
<td>99</td>
<td>100</td>
<td>98</td>
</tr>
<tr>
<td>Unfeasible</td>
<td></td>
<td>1</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Process</td>
<td></td>
<td>98</td>
<td>99</td>
<td>98</td>
</tr>
<tr>
<td>Unfeasible</td>
<td></td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Consistency</td>
<td></td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Unfeasible</td>
<td></td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Future prospects</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td></td>
<td>20</td>
<td>24</td>
<td>13</td>
</tr>
<tr>
<td>Unfeasible</td>
<td></td>
<td>80</td>
<td>76</td>
<td>87</td>
</tr>
<tr>
<td>Process</td>
<td></td>
<td>73</td>
<td>78</td>
<td>66</td>
</tr>
<tr>
<td>Unfeasible</td>
<td></td>
<td>27</td>
<td>22</td>
<td>34</td>
</tr>
<tr>
<td>Consistency</td>
<td></td>
<td>68</td>
<td>71</td>
<td>64</td>
</tr>
<tr>
<td>Unfeasible</td>
<td></td>
<td>32</td>
<td>29</td>
<td>36</td>
</tr>
<tr>
<td>Performance measures and indicators</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Content</td>
<td></td>
<td>88</td>
<td>91</td>
<td>79</td>
</tr>
<tr>
<td>Unfeasible</td>
<td></td>
<td>12</td>
<td>9</td>
<td>21</td>
</tr>
<tr>
<td>Process</td>
<td></td>
<td>95</td>
<td>96</td>
<td>94</td>
</tr>
<tr>
<td>Unfeasible</td>
<td></td>
<td>5</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Consistency</td>
<td></td>
<td>94</td>
<td>95</td>
<td>94</td>
</tr>
<tr>
<td>Unfeasible</td>
<td></td>
<td>6</td>
<td>5</td>
<td>6</td>
</tr>
</tbody>
</table>

Note: All data expressed as percentages of Total/Big Four/non-Big Four respondents.
Unsurprisingly, there is near universal agreement that content assurance is feasible for past results. There is very substantial agreement (88% of all respondents) that assurance over content is feasible for performance measures and indicators, while for key resources, risks and relationships 55% of each auditor sub-group believed that assurance over content was feasible. It is consistent with the results for the preceding question that future prospects is viewed as the most problematic content element although substantial majorities of each auditor sub-category stated that both process and consistency approaches were possible. Twenty percent of auditors believed that content assurance was possible although while 24% of Big Four auditors signalled positive views about assuring content of future prospects only 13% of non-Big Four auditors did so.

Summarising, no problems are envisaged in applying assurance over content to the more straightforward elements of management commentary. A substantial proportion of auditors appear to believe that such an approach is possible for some less straightforward elements, such as risk. The challenge, given evidence suggesting significant demand from users, is to develop acceptable assurance approaches for the most challenging and interesting categories of management commentary, particularly future qualitative information.

**Scope of assurance**

The three forms of assurance, consistency, process and content, were addressed in the interviews although discussion, rather than focusing specifically on these, tended to address them by considering content elements, such as future forecasts or risk, or information with differing, e.g. qualitative or quantitative, characteristics. Assurance on consistency was uncontroversial with auditors reiterating that this was an existing obligation. Some interviewees reflected the questionnaire results in suggesting this was the maximum possible for the more problematic
management commentary elements although one Big Four partner made the point that:

...we ought to be able to find some way of giving assurance on content because I think that with consistency we’re not really doing very much at all. (B4P6)

This reflects the traditional interpretation of consistency, i.e. with the financial statements. Another Big Four partner, however, emphasised the value of even this limited approach:

...I then go into the financial review and see if they are using the same figures that I see in the P&L; if they are not it means that they want to paint a different story which means that there is a problem somewhere… they have an exceptional item somewhere that has gone to the P&L account that is depressing profits, they want to take that out because they want to show that underneath they are actually very strong and robust. (B4P9)

Comments were made highlighting the more subtle nuances which might be placed on consistency; for example, consistency with understanding of the business.

I think we are obliged to comment if we believe there are any material inconsistencies between it and our understanding of the business. (NB4P8)

Suggestions, that assurance on content was difficult or impossible for the subjective or forward-looking elements of management commentary also reflected the questionnaire results. A significant number of interviewees stressed the appropriateness of assurance over process for such elements; it was again consistent with the questionnaire results
that most of the positive comments about process were made by Big-Four auditors. A more cautious comment, however, emphasised the consequent comparison difficulties.

...but the difficulty when applying that to the management commentary is that whilst a process of financial reporting is one thing, a process of some aspects of the management commentary is another thing and how would you compare the process that BP is applying for example with the process that a media company might apply. You could in the sense have they gone through certain steps in preparing information contained in the management commentary?... but what might those steps be? ...they might be too high level to be much use. (B4P10)

A Big-Four partner, an insurance specialist, suggested that often it was not always meaningful to distinguish content and process.

It can be a combination of both [content and process], I think; in life assurance we often look at what is called embedded value… there is data, there is a question about methodology which would be framed a bit like accounting policies, so is it done on a consistent basis to the last forecast management gave us? Or have they changed the methodology in any way? Then you do end up with assumptions, what are the key judgements that management have taken? How fast will growth be in the future? And then some of the questions asked would be along the lines does that tie up with any external forecasts that the world bank, the IMF or government put out?... or is it management’s own view that the UK or US economy is going to be in some way performing differently than that? So it does break down into data, methodology and assumptions and then there is a process point around the methodology. (B4P4)
Positive views on assurance

Most auditors interviewed agreed at least with the principle that there should be some degree of assurance.

*I think it is very desirable actually. I think readers of the accounts and the annual report want assurance that the numbers are reliable and that the comments are reliable, so certainly in terms of historical information there is no reason why auditors can’t give a degree of assurance on the contents. It probably gets more difficult when you get into forward-looking statements; then I guess it would have to be more about the process that management go through in making those statements rather than the actual predictions.* (NB4P6)

One partner from one of the larger non-Big Four firms related the desirability of assurance on management commentary to strong user demand.

*I think from the contact we have with stakeholders across the spectrum of large private and public companies there is an inexorable pressure that says they want some assurance and therefore as an audit profession we have to react to that... There are very, very few that are prepared to give management free reign without some external check on what they are saying.* (NB4P5)

A Big Four partner articulated the need for assurance on management commentary in terms of the need to give comfort over what mattered to market investors rather than over historic information.

*...if the aim of the management commentary is to provide context for the numbers that are given as a backward view and connect those into what we can expect of the future and what are the key
success drivers, then if you don’t have any assurance over it what comfort does the investor community actually have?... I think it is quite fundamental that you get some assurance because you are asking the market to work on information on which they have no comfort at all. (B4P7)

Another Big-Four senior partner, holding an important position within the organised accounting profession, made a similar point.

...if you look at our area of assurance we spend 90% of our time on the past and 10% on the future in terms of going concern and such like and actually if you look at the city they spend 90% of their time on the future and 10% on the past. Arguably, it’s because our job is to give them the firmness on the past and their job is to look at the future, but do we give them enough? If we take in management commentary you could then argue why do we give no assurance over presentations to analysts... there must be room for us to be able to find ways of giving a degree of assurance. (B4P6)

Another Big-Four partner, a financial services specialist, expressed the need for assurance not only in terms of the management commentary being an important component of corporate reporting but the concomitant need for cohesive assurance on the whole reporting package. He highlighted the limitations of present consistency approaches.

...I think omitting the management commentary leaves quite a big gap, particularly because the figures are quite hard to access and understand in isolation. At the moment we have a regime that says if directors put out their report, the auditors have to say if it is not consistent with the facts. Really all that does, if sales are a billion, then in the ‘front-end’ they don’t say it is a billion and a half and it sort of stops those kinds of excesses. (B4P4)
Thus important themes informing the thinking of those auditors in favour of assurance included the beliefs that: management commentary is a key component of corporate reporting, to omit it from assurance would leave a reporting gap, and that there was unsatisfied user demand for assurance. One of the most radical thinkers was a senior Big Four partner who had earlier expressed strong views about the need for more business focused reporting. His views were again expressed very much in terms of what the markets wanted.

_The thought processes and views of management need to be communicated to the market in a far more formal way. The auditors, who stand between the two, would need to express a view on it. At the moment companies are making strategy presentations to the market which we are not expressing views on. And the market doesn't know what we think about it... I think the market would be much more interested in our opinion of management's strategy presentation than they are in 12 pages of IAS 19 disclosures..._ (B4P11)

**Negative views on assurance**

The most negative comments made by interviewees tended to be grounded in either traditional conceptions of the external auditor role or in perceptions of little demand for assurance. It is fair to say that the most negative comments were not made by interviewees but by respondents to the questionnaire survey. Comments by responding non-Big Four auditors including the following:

_A crystal ball is not capable of being audited._ (Questionnaire comment)
There is an inherent difficulty in the audit of management commentary as inputs are subjective so I am not convinced it is feasible at all. (Questionnaire comment)

In my view there is little to be gained for the profession in seeking to expand the role of the auditor to this extent. It becomes very subjective and client relationships will be strained as a result and the costs and risks of auditing increased significantly. (Questionnaire comment)

While there was a significant amount of interview comment that might be interpreted as negative, very little of this rejected the proposition that management commentary assurance was desirable in principle. The following comments, however, constitute some exceptions being possibly the most negative made:

You’ve got to remember that the auditor is reporting on the financial statements... it’s not a holistic view. So while we try to understand the business it’s really management who have got a grasp of the whole picture... I think assurance would become very complex and I don’t know if at the end of the day it would end up adding a huge amount of value. (B4D2)

Because the commentary is generally in the ‘front-end’ of the report, there is a fair amount of factual information and we do have to comment, don’t we, if that factual information is actually inconsistent but in general that is limited to only a fairly small part of the report. I think we would have incredible difficulty in giving them another form of assurance about events which we have no expertise on. We don’t know the market in which businesses operate, that is not our role, is it? We know generally but we don’t know the detail. And we have absolutely no idea about how business is going to fare in the future. And I think to start commentating and
giving any sort of assurance on that may well be extending slightly into the management role. (NB4P3)

These two comments reflect traditional views of auditing. The following comment by an experienced Big-Four partner, however, reflects a view that user demand for assurance was problematic and that there were potential conflicts of interest:

*I think it’s going to be very difficult to have some form of assurance reporting on information on where the business is, how it fits in compared to that business’ competitors and on something that might be perceived as being seen as some sort of forecast or projection… I certainly think there are some inherent, very significant conflicts with asking the auditor to do any form of assurance work on that and I’m not sure really what purpose it would serve… there is far more information available to the general public now in terms of viewing analyst presentations and part of it is making an assessment of how credible you think management are, trying to gauge how much spin there is… I’m not sure assurance would serve much purpose at all. (B4P3)*

This partner explained his belief that information that might be given in management commentary would be inadequate for investment purposes, certainly within the context of the banking industry which was one of the areas in which he specialised. In summary, there appear to be comparatively few auditors opposed to assurance on the ‘front-end’ in principle. However, those who accepted the desirability of assurance on management commentary in principle but had reservations as to its practicalities were more numerous. These were generally thoughtfully expressed and for the most part divided into two categories. Firstly, there were perceptions about the difficulties of opining on particular content elements, e.g. forecasts, or information characteristics, e.g.
Can we meet the needs? Auditor views on external assurance and management commentary

qualitative information. Secondly, and probably more significant, were more general concerns such as litigation or the perceived difficulty in determining acceptable and feasible forms of audit reporting. Clearly both categories of reservation require addressing before any proposed assurance standard would be acceptable to auditors and so we address them both here. At the same time, many interviewees made positive comments about assurance possibilities.

Quantitative information

Predictably, opining on present or past quantitative data was regarded positively, less expected was the significant amount of positive comment about the ability to provide assurance on future quantitative data. There was more positive comment as to auditors’ ability to engage with these areas than might be expected from the questionnaire results. There was recognition that auditors already evaluated forecasts when assessing going concern status and as part of due-diligence exercises, e.g. for banks or other lenders.

I think to the extent that numbers form a part, that is a relatively known metric... that we should be able to get our heads around when giving assurance. It may be slightly more difficult and it may push us into looking at systems and processes for non-financial data which we otherwise wouldn’t have done. (B4P5)

We are clearly comfortable and capable of providing assurance on any numerical or quantitative analysis... We can provide some assurance on forecasting... We can provide assurance on the robustness of the forecasting model, we can provide assurance on some of the assumptions that go into a forecasting model, we can provide quantitative analysis on forecasts such as sensitivity analysis...
around key assumptions. The area in forecasting that we are less capable of dealing with is risks to the business model. (NB4P5)

These opinions indicate relative comfort when dealing with numerical analysis whether financial or not. There is a suggestion in the second quote that larger, particularly Big-Four, firms might cope more readily with assurance on non-financials because of the broader resource base available to them. However, this partner in one of the larger non-big Four firms, who had previously been with a Big Four firm, played this down.

The larger the firm might be the more it is able to invest in narrow sector specialisms but my experience of [XXXX], a very large firm, and [YYYY], a less large firm, suggests that the same issues are there. There is a line to be drawn between moving away from financial and operational analysis into technical and market analysis and none of the audit firms have, at this moment anyway, moved significantly into technical market analysis. There are some exceptions and there are exceptions within [YYYY]. For example, we have professional surveyors in our real estate technical business who help us on technical valuations, e.g. the market risk, and ditto in [XXXX] and probably the other Big Four. We have market and risk analysts in our financial sector business as there is in [XXXX]. (NB4P5)

Much of the discussion around quantitative information was centred on financial forecasts and so the following section considers these specifically.
Forecasts

There was significant positive comment, consistent with the preceding extracts, about the ability to provide assurance on forecasts although this was not unqualified.

*Shouldn’t be beyond man to find a way of doing it because frankly you do it on diligence assignments and such like as we stand but there just might be a lot of difficulty around it.* (B4P6)

This auditor, and others, envisaged difficulties on issues such as litigation and the audit expectations gap; the technicalities of appraising forecasts were not envisaged as a problem. What was a concern, was the nature of the specific assurance which might be provided given the subjective nature of some content; this applied even to relatively ‘hard’ future-orientated information.

*Well, obviously the mechanics are technically feasible but if you get into questions such as why they’ve assumed GDP growth of 2% and you know that a range of judgements on GDP growth is between 1.5% and 3.5%, what assurance can be given on that other than there is nothing in there that is incorrect, or false, but that’s a rather negative approach to life.* (B4P2)

*If you are looking at financial forecasts, you can audit a spreadsheet with budgets, forecasts, cash flows... what you can’t audit is the human factor... We don’t work in the future so if you are going to bring the future in then you have got to make it very clear it is different...* (NB4D1)

*I think it’s definitely easier [than for more qualitative information] to have assurance over financial information*
forecasts, future financial information... What type of assurance that gives you, I think, will be up for debate. Certainly it would be inconsistent if an auditor was almost giving a certificate that the forecast was close to reality, but there is clearly work that we can do in the profession in terms of checking its mathematical accuracy, making sure that the key assumptions in that forecast were disclosed... I think that could be valuable to investors as long as it wasn't perceived as being some form of guarantee on the forecasts... (B4P3)

I think that you have got to be very guarded about how the opinions reflect what you have done in that area and how people might choose to use that, but we do work on forward-looking information. I think one can make judgements about whether assumptions are sensible or whether those are the assumptions that actually have been applied...the going concern is essentially around that which is something we have been focusing on especially over the last 12-20 months. So for us as a profession to turn around and say we don't do that... well that is nonsense because accounts are prepared on a going concern basis and therefore must pay due attention to what is going to happen beyond the balance sheet date... (B4P5)

These quotes reflect auditor opinion on a strategically important aspect of management commentary. The views of most interviewees could be positioned somewhere close to one of these four extracts which are given in an increasingly positive order. The last reflects a view which recognises difficulties but also that the profession requires more obvious involvement with this area. While a significant element of the perceived difficulties relating to assurance on forecasts revolved around the precise form of assurance provided, some auditors suggested specific ways to achieve this.
We could give an opinion as to whether we believed management’s assessment both on the past and on the prospects for the future were consistent with our understanding of the business and the industry. People don’t appreciate that when you are auditing an impairment test you are auditing a financial forecast. Long-term provisions are financial forecasts and a lot of the numbers in accounts are based on long-term forecasts. (B4P11)

I think the challenge is what the report looks like. Our view on this is constrained by historic assurance reports as opposed to thinking how we can help the market and what form of words can give it some assurance while alleviating some of our justifiable fears that we could lay ourselves open if we are too strong on the assurance that we give... so to give some more outward-looking assurance we would have to think about what is it in that forecast that people are really worried about. (B4P7)

These two extracts suggest that much of what users would find valuable in terms of assurance on forecasts is consistent with other existing professional work; once again the challenge is how to formulate the assurance offered. There is some suggestion of an eventual move away from the true and fair opinion. Generally, then, the prevalent view was that assurance on forecasts, and forward-looking information generally, was possible. Such positive views were not restricted to younger, Big Four partners; for example, a senior partner nearing retirement from a smaller Top 20 firm emphasised the need for the profession to be innovative.

It may well be that the audit or assurance profession if you like has to start embracing these new areas... We can easily look at current market trends in particular business areas... and perhaps even provide a commentary on management commentary. ...I realise there are huge issues of liability and what exactly you are reporting and to whom but some of the work that would be done in that
context would be done in due diligence contexts anyway... In order to properly deal with your going concern review you do need, if not to look forward, at least to consider how management have looked forward and how they have seen the next year and their profitability, cash flow, cash requirements, resources available... It is not particularly difficult probably, then, to extend that to assurance on other outside data... The dyed in the wool people like me will have a considerable difficulty with that because it means learning a new discipline... But it is not impossible, things have changed so dramatically since I first came into the profession and it is going to continue to change. (NB4P3)

This carefully considered opinion while that of a self-confessed 'traditionalist' nearing the end of his career nevertheless envisages the need for auditors to extend the assurance they offer. Although not specifically addressed in the interviews, one or two auditors suggested that assurance on forecasts might encapsulate some sensitivity analysis. One Big Four banking specialist made the point that:

*If you look at IFRS 7 there is sensitivity analysis required around financial disclosures. So right now we provide a full audit opinion on sensitivity analysis on fair value disclosures... We would have to think about how the wording was and what expectations were but why should it necessarily be any different to the sensitivity analysis we do on fair value?* (B4P8)

Another banking partner made a similar point.

*What I think would be more useful actually is something in the way of sensitivity analysis as to what the potential scenarios are that could happen to the business... The investor community could*
then make their decision as to what they actually think would be most likely to happen... (B4P7)

In summary, then, assurance on forecasts, or quantitative information generally, is regarded positively with some suggestion that this could be relatively sophisticated.

**Qualitative information**

While there was relatively little comment specifically on assuring qualitative information, these were less positive and, as such, consistent with the questionnaire results. Several auditors, however, emphasised that qualitative factual information could be checked. One very senior Big Four partner made the point that management could be asked to justify making statements that were in the nature of opinion and suggested this as a means of assurance.

*We’ve had conversations in other contexts with clients who have perhaps described something they’ve done... ‘Great performance in one area’... and you say ‘Well how do you define great?’ and ‘How can you show that this was great performance in a particular area?’... So you are trying to take away some of the PR spin and saying ‘What are the facts and do the words that you are using support the facts? Do the facts support the words you’ve used?’ This is where you get into some interesting conversations around materiality... does this statement affect the whole tone of the management commentary or not. So it’s not easy, but it’s not impossible. (B4P12)*

While several interviewees believed that exercising the judgements envisaged here would be an invasion of management territory, another Big Four partner firmly rebutted such views:
I don’t think we would be commenting on the business... I think we would be commenting on management’s commenting on the business... my vision would be that our job is to make sure that management is giving a fair and reasonable assessment of the past performance and prospects for the future. In extremis if we thought that there are material statements not being disclosed we would disclose it in our report. (B4P11)

The issue as to whether auditors opining on management judgements, whether specifically in the management commentary or not, is a colonisation of management’s domain is discussed in chapter seven on audit reporting.

Risk

Risk was addressed in the interviews as one specific qualitative area on which assurance might be provided. Auditors were generally positive on this; it was emphasised that auditors were already involved with risk. Once again, however, the liability issue was highlighted.

Interestingly risk is an area where we should be more comfortable because of course we rely heavily on risk-driven processes to drive our risk-based audit. So it should be an area that we are pretty comfortable with... So, yes, we could go into that space but we wouldn’t go there with the current litigation regime without a framework that describes what we have done, that gives us all clarity about what we have done and what assurance a third party user should take from those words. (B4P7)

Your instinct as an auditor is ‘ugh we don’t want to do that’ but then... How do we do our audits? ...we look for risks and the bulk of our work is directed at those risk areas. We do not spend hours fiddling about with immaterial non-risky bits of our clients’
balance sheets and P&L accounts. So by the back door we do that to some extent but what I suppose we don’t do definitively is say, yes, the risks they have listed in the management commentary are the risks. I guess it probably is a liability issue... we have quite a sophisticated client who had not spotted a risk and, frankly, nor had we, because it was a risk that came out of the blue, something like a distributor going bust overnight which just wasn’t anticipated by anybody and you know that will make you a little bit nervous I suppose about doing these things. (B4P5)

Thus in risk, as in other areas, auditors have competence to offer assurance that goes further than their present limited involvement. Audit liability and reporting, however, appear to be substantial barriers to meaningful assurance. One or two auditors from smaller Top 20 firms suggested their firms might not have the resources in this area that would be available to the Big Four.

I don’t see any reason why auditors can’t [assess risks within management commentary]. If you look at future forecasts you have really got to look at risks as well. What would worry me slightly is that the people who would have the resources to do this I suspect would be the big firms. (NB4P3)

Thus there may be issues in terms of the resources available to different firms when providing assurance on less familiar aspects of management commentary.

Key performance indicators (KPIs)

Auditors’ perceptions of their ability to provide assurance on KPIs are largely positive and consistent with the questionnaire results. There was some suggestion that assuring non-financial KPIs might be very
expensive and a Big Four questionnaire respondent suggested that ‘there are huge variations in complexity in KPIs between industries and between companies within industries’.

In summary, while opining on qualitative areas is seen as relatively challenging technically and while there are perceptions of resource issues, the major obstacles to be addressed are reporting style, auditor liability, and confusing the respective responsibilities of management and auditors. Nevertheless, it was considered to be appropriate to include a question in the questionnaire on enhancing auditors’ technical capacities; this is discussed in the following sub-section.

**Enhancing auditors’ technical capabilities**

The results for the survey question eliciting views on three possible mechanisms to enhance auditors’ capability to provide management commentary assurance are shown in Table 5.4.

**Table 5.4 Perceptions as to helpfulness of means of enhancing technical capability to provide assurance on management commentary**

<table>
<thead>
<tr>
<th>Means of enhancing capability</th>
<th>Total</th>
<th>Big Four</th>
<th>Non-Big Four</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
</tr>
<tr>
<td>Revised auditor education (e.g. greater emphasis on factors such as commercial awareness or business forecasting)</td>
<td>2.20</td>
<td>0.80</td>
<td>2.25</td>
</tr>
<tr>
<td>Employment of more specialists (e.g. in specific industries or business forecasting)</td>
<td>2.29</td>
<td>0.87</td>
<td>2.25</td>
</tr>
<tr>
<td>Revised auditor methodologies (e.g. greater emphasis on areas such as business risks, future prospects)</td>
<td>2.54</td>
<td>0.80</td>
<td>2.50</td>
</tr>
</tbody>
</table>

**Notes:**
There are no significant differences between the mean scores awarded by Big-Four and non-Big Four auditors.

**Scale:** 1 = Very helpful  2 = Helpful  3 = Neutral  4 = Unhelpful  5 = Very unhelpful
The results suggest that, in particular, revised auditor education and the employment of more specialists are regarded positively. All three options were signalled by at least 50% of responding auditors as being ‘very helpful’ or ‘helpful’ in enhancing the technical capacity of auditors to provide assurance on management commentary. There were no significant Big Four/non-Big Four differences. One Big Four respondent was cautious as regards employing specialists in that: ‘industry and subject experts tend to have less commitment to excellence and high ethics’. The interviews did not place emphasis on this area but one senior partner from a larger non-Big Four firm was also cautious about over-reliance on non-audit specialists.

More and more the skills base is having to be broadened to using experts and that is a worry... where does that responsibility begin and end?... is there going to come a point where the actual auditor is relying so much on a whole series of experts that they are not able to form a view of their own? So I think we have to be slightly careful that the standards on the use of experts don’t drive us down too much of a line that suddenly it is someone else’s responsibility. (NB4P6)

A partner from a smaller non-Big Four firm, who had previously trained with a Big Four firm, commented on the relative specialist resources available to larger and smaller firms; these comments echoed earlier comments regarding risk.

If you look at the Big Four... they’ve got property valuation experts, mining experts, they’ve got actuaries that are employed directly by the firms, they’ve got a lot more legal in-house expertise. So, they’re probably not that far away from being able to give assurance on all kinds of information that’s in the management commentary, but any mid-tier firm of similar size to us would have to go and get external experts to report on those things to us... and I think the
more it is expected that auditors are experts on everything rather than just financial reporting there becomes a division between the biggest firms and the others. (NB4P7)

Thus widening the scope of assurance may cause starker distinctions between Big Four and non-Big Four firms. Discussion on auditor education and on audit methodologies and the audit process took place in a more general context than purely management commentary and are covered in chapter six.

Management commentary assurance and auditor liability

Auditor liability inevitably intrudes into any extended discussion of management commentary assurance and was addressed in the interviews. Auditor liability generally is covered in chapter six while this section covers the topic in the context of management commentary. The prevalent view was that revision of the liability framework would be useful and, according to some auditors, essential. The unlimited liability on audit assignments was contrasted with the ability to limit liability on arguably riskier work in areas other than statutory audit.

The irony is that... audit is the only area of work where the legislation says that you cannot get any protection. For the riskier stuff – the shareholder circular stuff, the due diligence work, the insolvency work, acquisitions, disposals, tax work – you have terms of reference; we have a letter of engagement that limits liability... If we get it wrong nothing will save us but if we don’t get it wrong and it is judgemental you can only sue us to a maximum. (B4P9)

If you look at what we do with our CSR reporting quite often we do seek to limit our liability. (B4P12)
These views suggest that management commentary assurance has more in common with these areas than with statutory audit and that some relaxation of liability would be appropriate. This was spelt out explicitly.

*In the microcosm of the single audit on a single organisation I don't think the current litigation climate would significantly influence the thinking or the nature of the work of an auditor – the audit is conducted in accordance with auditing standards, in accordance with the firm's procedures and that is what is in the front of the auditor's mind – but strategically it clearly has an influence on the degree to which we are prepared as a profession, not as a firm, but as a profession, to try to influence the nature of the assurance that we give. That is inevitably restrictive because of the litigation and liability environment.* (NB4P5)

*You're not going to get any of the firms signing up to something that would expose them to litigation risk. At the end of the day, we don't bet the firm on anything.* (B4P3)

Many similar comments were made; one emphasised the need for liability concessions for both company directors and auditors.

*I think both directors and auditors need safe harbour in order for management commentary to be meaningful; otherwise you are just going to get boilerplate.* (B4P11)

In summary, revision of the liability framework may be essential before the auditing profession is willing to consider substantive assurance on the ‘front-end’. Of course, there are other perspectives; some of the users who participated in the first research stage believed that further liability concessions to auditors would be inappropriate and, as highlighted in chapter nine, there is a view that the profession has
not utilised existing liability concessions available through the 2006 Companies Act.

**Costs of management commentary assurance**

Two questions were incorporated in the questionnaire survey on the costs of providing management commentary assurance. The first asked respondents to comment on the reasonableness of suggested estimates of the additional costs which might result from providing assurance of differing scope. The results are shown in Table 5.5.

**Table 5.5  Perceptions of reasonableness of estimates of providing assurance of differing scope on management commentary**

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Big Four</th>
<th>Non-Big Four</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
</tr>
<tr>
<td>Audit of content: estimated cost £30K - £150K</td>
<td>2.91</td>
<td>1.25</td>
<td>2.35</td>
</tr>
<tr>
<td>Audit of process: estimated cost £15K - £70K</td>
<td>2.83</td>
<td>1.18</td>
<td>2.39</td>
</tr>
<tr>
<td>Audit of consistency: estimated cost £10K - £30K</td>
<td>2.82</td>
<td>1.18</td>
<td>2.44</td>
</tr>
</tbody>
</table>

Notes:
1 Significant difference at 1% between the mean scores awarded by Big Four and non-Big Four auditors.
34 out of 123 respondents felt unable to express an opinion as to whether the estimates were reasonable or unreasonable

Scale: 1 = Very reasonable  2 = Reasonable  3 = Neutral  4 = Unreasonable  5 = Very unreasonable

The summary figures indicate that respondents were generally neutral about the estimates provided although the standard deviations indicate significant variation in view. There are two notable features of the responses. First, 28% (34) of all respondents (128) were unsure as to whether the estimates provided were ‘reasonable’ or ‘unreasonable’ thus
highlighting the uncertainty on this issue. Second, by way of contrast to most of the survey questions, there are significant differences in the mean responses of Big Four and non-Big Four auditors. The latter appear to regard the estimates provided as mildly reasonable in contrast to Big Four respondents whose view is at best mildly unfavourable. The most plausible reason for the Big Four/non-Big Four difference is the relative fee levels for each firm category. Around one third of respondents did score the estimates provided as ‘very reasonable’ or ‘reasonable’. A follow up question invited respondents who scored the estimates provided as ‘unreasonable’ or ‘very unreasonable’ to indicate alternative cost ranges. Table 5.6 highlights the absolute number of respondents who fell into various categories; those who disagreed with the estimates provided, regarding them as unreasonable or very unreasonable, are divided into those who suggested either lower or higher ranges as well as those who made no suggestion. Table 5.7 indicates the alternative ranges of costs proposed.

Table 5.6 Agreement (absolute numbers of respondents) with suggested ranges of additional costs resulting from providing assurance on management commentary

<table>
<thead>
<tr>
<th></th>
<th>Audit of content</th>
<th>Audit of process</th>
<th>Audit of consistency</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Min</td>
<td>Max</td>
<td>Min</td>
</tr>
<tr>
<td>Suggested range</td>
<td>£30K</td>
<td>£150K</td>
<td>£15K</td>
</tr>
<tr>
<td>Agree range or neutral</td>
<td>54</td>
<td>54</td>
<td>53</td>
</tr>
<tr>
<td>Disagree – lower</td>
<td>7</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Disagree – higher</td>
<td>8</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Disagree – no suggestion</td>
<td>13</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>Don’t know</td>
<td>42</td>
<td>42</td>
<td>43</td>
</tr>
</tbody>
</table>
Table 5.7 Alternative ranges of estimated costs proposed for assurance on management commentary

<table>
<thead>
<tr>
<th></th>
<th>Audit of content</th>
<th>Audit of process</th>
<th>Audit of consistency</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Min</td>
<td>Max</td>
<td>Min</td>
</tr>
<tr>
<td>Suggested range</td>
<td>£30K</td>
<td>£150K</td>
<td>£15K</td>
</tr>
<tr>
<td>Alternative – minimum</td>
<td>£2K</td>
<td>£5K</td>
<td>£2K</td>
</tr>
<tr>
<td>Alternative – maximum</td>
<td>£100K</td>
<td>£5M</td>
<td>£50K</td>
</tr>
</tbody>
</table>

Table 5.6 indicates that as far as content and process approaches are concerned, more respondents regarded the ranges of additional costs provided as too low than too high; with consistency, however, this reverses. Table 5.7 indicates the wide variety of suggested alternative costs. In the interviews, auditors were asked about their ‘gut feelings’ as to the percentage which substantial assurance might add to the total external audit costs of the typical listed company. While a few individuals stated that the issue was too complex for such a simple response, the incremental percentage proposed ranged from 10% to over 100% with a mean and mode of perhaps 20-25%.

The point was made more than once that assurance on management commentary might be subject to some degree of economy of scale and so incremental costs for the largest companies might be expected to be proportionally lower than for smaller entities. A Big Four partner working at the high end of the FTSE 100 suggested that:

*I don’t think it would add more than 10% onto the fee... assuming you had safe harbour and you are therefore not putting a risk premium on it. If you look at the few companies that produce what I would call serious sustainability reports which are audited and you have a high degree of assurance very much along the lines I am talking about – which is assurance over process and*
the fairness of the statements and additional observations – the fee for the sustainability report is about 10% or less of the audit fee. I think that 10% would be a reasonable estimate. (B4P11)

There is a connection made here, once again, between extending assurance and auditor liability. Other interesting points were made by another Big Four partner, one whose partner level experience was mostly with medium-sized listed companies.

If I was a board of directors and I had a good ‘front-end’ to my accounts I would regard that as probably quite important... but a client who is fatigued with audit costs may have a different view. Again, you have got to remember that audit costs generally are actually very, very small proportionately but are a very visible proportion of general expenditure for most of our clients? (B4P5)

The suggestion of benefits accruing to medium sized companies from assurance on the ‘front-end’ reflects the point made by interviewees about being asked by some clients to provide assurance on management commentary. The point about the visibility, as opposed to the magnitude, of audit costs, is noteworthy.

In summary, while opinions vary significantly as to the likely costs of assurance on management commentary, as indeed was the case with users, there is no sense that cost is likely to derail the provision of assurance or determine which specific form might be provided. There is a hint that liability issues may determine whether management commentary would carry a risk premium. In general, those who expressed less positive sentiments about assurance, tended to propose higher percentage incremental costs.
Summary

This chapter explores perceptions relating to providing external assurance on management commentary. The findings may be summarised as follows:

• Both Big Four and non-Big Four auditors believe it is important to provide assurance on management commentary and auditors are, if anything, more positive on this fundamental issue than both the investors and non-investor users surveyed at the first research stage. There is no significant difference between Big Four and non-Big Four auditors’ opinions.

• The importance of assurance was scored extremely highly for the more straightforward and less contentious ‘content elements’ of management commentary; most obviously for historic financial information. Views on assuring future financial information are less clear cut but a very significant proportion of auditors nevertheless indicated that assurance over this area was important and feasible. Auditor views regarding assurance on future-orientated financial information appear to be more positive than those of investors.

• Views on three forms of assurance (content, process and consistency) were elicited in respect of both specific ‘content elements’ and management commentary information with differing characteristics. Assurance on historical financial quantitative information is, unsurprisingly, viewed as unproblematic with a clear consensus that any of the three proposed forms of assurance was possible. Views on the assurance of historical quantitative non-financial information are still positive with a majority of auditors signalling that any form of assurance was possible.

• With historical qualitative information, with future quantitative information (financial or non-financial) and, most clearly, with future
With the more challenging categories of forward-looking information, views are less positive especially for forward-looking qualitative information. While only a small minority of auditors believes content approaches are feasible, majorities or substantial minorities believe that consistency or process approaches are feasible.

Some divergences of view between Big Four and non-Big Four views are apparent. Big Four auditors exhibit relative preference for process forms of assurance for past qualitative and non-financial quantitative information; possibly reflecting greater familiarity with systems-based assurance.

The interviews largely reinforced the questionnaire results; if anything, interviewee views were more positive. Most interviewees were thoughtful individuals seriously concerned about the future of the profession. There is little opposition to management commentary assurance in principle; reservations tend to be couched in terms of the difficulty in agreeing acceptable forms of reporting given existing auditor liability arrangements.

Most auditors do not envisage technical obstacles to assurance on future-orientated, particularly forecasted, information. Parallels were drawn with due diligence and similar engagements. Auditor liability reform, however, is seen as key to meaningful involvement in this area. Positive comments were made about auditors’ ability to provide assurance on specific areas such as risk.

There is much uncertainty as to the likely costs of providing assurance on management commentary, reflecting the difficulties in reducing
varying sizes of listed company, as well as variegated industries, to a common formula. The interviews revealed that while there is a perception that substantive assurance would involve significant incremental costs, there is little sense that cost would prove an insuperable barrier to providing assurance. Big Four auditors assert that management commentary assurance would be significantly more costly than non-Big Four auditors.

• Questionnaire respondents indicated that revised auditor education and the employment of more non-audit specialists might help firms to provide ‘front-end’ assurance. The interviews suggested that greater employment of non-audit specialists might reinforce the divide between the largest audit firms and others.

• At present, there is no generally acceptable reporting format for management commentary assurance; there are perceived problems about true and fair reporting. Chapter seven deals with reporting in detail.
Process, Rules and Judgement

This chapter deals with views on the relative emphases afforded to process, rules and judgement in contemporary auditing. More specifically, the chapter deals with views on issues such as the tension between ‘rules’ or ‘rules-based judgement’ and exercising professional judgement. Also discussed is the impact of recent regulatory change on the exercise of judgement by auditors, and whether this has facilitated an emphasis on process-driven auditing. While these issues do not map directly onto the central research issues, they are relevant. The first research stage elicited the perceptions of both investors and other users as to the robustness of the contemporary audit process as it was considered that these might influence perceptions of the desirability of management commentary assurance. The first research stage indicated (see Fraser et al., 2010, page 126) that, generally speaking, users were at best only mildly confident in the external audit process.

Impact of rules and regulation

It was thought that asking auditors directly about their confidence in the audit process would not encourage engagement with the research. Instead, the questionnaire survey included a question eliciting perceptions about the recent impact of ‘an increasing volume of rules and regulation’ on audit quality. The intent of the question was not to suggest that rules and regulation were synonymous, since regulation itself may be principles-based, but to highlight ‘rules-based’ regulation. Comments by respondents suggest that this was how the question was interpreted. A secondary, open-ended, part of this question invited comments on three specific concerns raised by users in the interviews executed at the first research stage. These were that: audits are driven...
by process and rules rather than by judgement; audit staff are often too inexperienced commercially; and audits involve too little substantive testing. The results for the primary question are shown in Table 6.1.

Table 6.1  Effect of increasing rules and regulation on the quality of audit practice

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Big Four</th>
<th>Non-Big Four</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
</tr>
<tr>
<td>Quality of audit practice</td>
<td>2.87</td>
<td>1.06</td>
<td>2.83</td>
</tr>
<tr>
<td>Quality of audit practice as perceived by users</td>
<td>2.96</td>
<td>0.85</td>
<td>2.96</td>
</tr>
</tbody>
</table>

Notes:
There are no significant differences between mean scores awarded by Big Four and non-Big Four auditors.

Scale: 1 = Very beneficial  2 = Beneficial  3 = Neutral  4 = Unbeneficial  5 = Very unbeneficial

The results suggest that auditors generally are fairly neutral as to the effects of rules-based regulation, whether in reality or as perceived by users. There are no significant differences between the perceptions of Big Four and non-Big Four auditors. There is a significant lack of consensus, however; particularly as regards the effect of rules-based regulation on actual audit quality. While approximately 45% of respondents scored this as ‘beneficial’ or ‘very beneficial’; approximately one third scored the effect as ‘unbeneficial’ or ‘very unbeneficial’.

A substantial proportion (42%) of respondents commented on audit quality generally or on one or more of the user concerns highlighted in the open-ended part of the question. The concern which attracted most comment was the suggestion that audits were driven by process and rules rather than by judgement. Consequently, this issue was also explored in the interviews and the following sub-section draws on both questionnaire and interview material.
Process, rules and judgement

On balance, most comment on this subject, in both questionnaire and interviews, was negative in that a perceived overemphasis on process or rules, and/or a declining exercise of judgement, was highlighted. In many cases, these perceived phenomena were attributed to current approaches to audit regulation. Comments were not overwhelmingly negative, however, and there was some comment commending recent regulatory change, particularly the approach of recent International Standards on Auditing (ISAs). Questionnaire comments included:

- There is substantial disconnect between audit quality as perceived by the regulators and audit quality as perceived by investors. The regulators view audit quality as an exercise in process and rules. Hence auditors focus on process and rules at the expense of other aspects that would add to audit quality. (Questionnaire comment)

- The increasing regulations, particularly ISAs, have without doubt led to audits becoming more process and mechanically driven, reducing the need for, and ability of, auditors to make judgements. (Questionnaire comment)

- Recent developments in auditing standards emphasise compliance. We now have a situation where 80% of time spent on an audit is there to justify regulators. (Questionnaire comment)

These comments, and others, depict an audit environment characterised by decreasing scope for professional judgement, onerous and intrusive rules-based regulation and a blurring of the distinction between regulatory compliance and audit quality. Similar sentiments were expressed by interview participants. A non-Big Four partner with Big Four experience suggested that:
I think that even partners are feeling less confident in their own judgements these days because they’re worried: ‘Do the ISAs let me do this?’ I can’t remember what all the requirements of the ISAs are and it used to be my judgement that was the key thing I relied upon but now I’ve got to go back and check whether this is something that is specified or not. And also there’s the worry that ‘Well, I’m happy with this’ but almost trying to second guess what the regulators might say if they came to review this file. With junior staff I don’t think there is as much judgement and I worry that in 10 years time when they’re the managers and the partners they’ll find it really difficult. (NB4P7)

What is particularly interesting about these remarks is that they were made by a young partner of only two years standing who perceived a significant change in the balance between process and judgement over her relatively short career. At the other end of the spectrum a senior Big Four partner in the twilight of his career expressed a similar view.

The whole focus of regulation in terms of things like the framework that sits round us now, the right framework in terms of the AIU [Audit Inspection Unit] and what they’re doing in terms of where auditing standards are going has been hugely down the route of process documentation, evidencing. Back in the 80s I was actually asked to use my judgement; now I’m actually asked to follow a process. (B4P1)

Although not a specific research concern, auditors commented on the Audit Inspection Unit (AIU) of the FRC; some, again, of a negative nature although some of a complimentary, or at least sympathetic, nature. For example another experienced Big Four partner commented on judgement versus rules as follows:
I think you fundamentally still can make judgements and I think it is just a question of being clear about what they are and how one has arrived at them and documenting that appropriately in the eyes of the regulator. ...So I don’t think it is something you blame per se on the regulators – I think it is more at the standard setting level where you end up with some ridiculous answer... for instance the classic answer of IFRS for a holding company investment and loans to subsidiaries being treated differently as to foreign exchange gains and losses, one going through the STRGL and one going through the profit and loss account...I think the AIU are presented with quite a challenging task frankly ...I certainly don’t think it is anything to do with their approach; it is more to do with the approach we have taken in terms of setting standards. I think that has reduced levels of judgement or reduced the opportunity to apply judgement. (B4P5)

There was other similar comment; several auditors indicated sensitivity to the difficulties and challenges posed by audit monitoring. It is, however, fair to say that positive comment was outweighed by critical comment on the AIU or on the regulatory environment generally; specific gripes included the percentage of audit time spent in preparing audit files for possible regulatory inspection. While the interviewee quoted above asserts that judgement is still integral to the audit, he pinpoints accounting, rather than auditing, standards as a major cause of its partial removal. He was not unique in so doing; indeed other research participants positively commended auditing standards, at least in ISA reincarnation, for enhancing the exercise of judgement. The following two comments were made by questionnaire respondents.

Process and rules have improved standards and approach. They allow clarity as to where and what judgements are being made and the documentation of same. In my view the root of user concerns
is more related to a desire not to pay for the hours involved.  
(Questionnaire comment)

ISAs have driven a more risk-based approach which requires judgement of relatively experienced auditors. (Questionnaire comment)

A senior partner from a larger non-Big Four firm associated both recent iterations of auditing standards and the work of the AIU itself with a judgement-centred approach.

_I think with the revision of the auditing standards... and also with the focus of the AIU and other regulators on audit and judgements... there really is a big focus again on professional judgement..._ (NB4P6)

An interesting sub-text in several interviews, particularly with Big Four auditors, was the suggestion that an arguably greater emphasis on process, might be explained other than by current regulatory emphases.

_Maybe people spend less time walking around a client then I did in my day ...you walk into an audit room and you see the youngsters all sitting there with their laptops open... I'm a great believer in saying to the guy 'shut the laptop and go and talk to the client'... we still actively encourage our people to use the judgement that's appropriate for their level in the organisation._ (B4P12)

_Yes, it [the judgement versus process issue] is a challenge to some of our team and you say ‘how often did you get out of the audit room?’ and they're keying away at stuff... One of my partners went out to a client and the first thing he did was ask ‘How have they done? What's the profit?’ and the team all looked at each other... they'd been there for 3 weeks or something and they were running_
a great process... but they actually didn't know what the business was... we're now doing special events for the teams trying to get them into understanding business in a wider way. (B4P6)

Other comments echoed this acknowledgement of the negative effects of IT on audit field work. There is also evidence here of senior auditors emphasising the importance of professional judgement to junior auditors while at the same time recognising difficulties resulting from the firms’ modus operandi.

The younger guys are quite process driven because we bring them in as graduates, they are very bright, they have learnt to do their own studying, they are off the wall, they are not bound by anything, they learn to question and all that sort of stuff because that is what higher education does to you, challenge whatever, nothing is out of bounds. We come in and it is smack, smack, smack! ...this is the methodology, the procedure, you have got to follow, you have got to do that, you have got to do it properly... and then we expect them to be off the wall guys and advising our clients on acquisitions and new systems and so on. We force that creativity out of them and expect them to be creative. (B4P9)

This acknowledgement that the way the firms worked was itself a constraint on auditors’ judgement reflects the views (discussed in chapter nine) of a regulator who suggested that it was disingenuous for the profession to argue that regulation had multiplied process; instead, process had resulted significantly as a consequence of large firms’ desire for uniformity of approach firm-wide. Thus there are varied perspectives on whether process now dominates judgement in the audit process and, if so, what the reasons for this are. The following comment by a questionnaire respondent represents a balanced view:
Audits are driven by process but at present there remains a suitable application of judgement in where to focus work and in assessing the financial statements as a whole. (Questionnaire comment)

Irrespective of individual views, however, it is impressive how seriously the auditors who participated in the research regarded these issues. While some senior partners were particularly trenchant when expressing their views on how exercising judgement was, at the least, less straightforward than it had been in the past, younger partners and other auditors certainly did not discount its importance. A young, recently appointed, Big Four partner commented:

If you look at some of the more senior partners, they would still go with intuition and some more junior partners, like me, would look more at the process... I think actually in some ways the safest place to be is to have a bit of intuition, because that tells you the right answer followed up by some validation by looking at whatever it is you need to look at... But a lot of it comes through experience because your intuition is only as good as the knowledge you’ve gained and so in the case of someone like me who’s only been in the practice ten years, my intuition is not going to be as good as somebody who’s been here 35 years because I’ve not got all the errors that they’ve made in the past to help form my knowledge and give me boundaries. (B4P8)

Such comments do not sit easily with arguments that contemporary auditors are insufficiently sceptical (see FSA & FRC, 2010).

In summary, there was certainly a sense that judgement is still fundamental to audit quality and that, for the most part, there was still scope for exercising it regardless of the impact of regulation. The prevalent view, however, was that regulation had influenced the exercise of judgement adversely.
Process, rules and judgement: Implications for management commentary assurance

While the implications of the judgement-process dichotomy for management commentary assurance were not addressed directly, interviewees’ comments afforded useful insights. Chapter five identified some strong views favouring process approaches for the more problematic content elements of management commentary. Arguably this sits oddly with an emphasis on judgement. One Big Four partner stated that:

...assurance on management commentary would require to be quite closely prescribed because otherwise you would have different forms of assurance across different companies. (B4P2)

Another senior Big Four partner expressed a rather different view, arguing that assurance on management commentary might actually facilitate greater emphasis on judgement.

In some senses you can say going into the management commentary actually allows a greater focus on judgement... I got a set of client accounts sent through to me the other day from one of my senior managers and she said ‘here’s the accounts, you’ve seen this, this and this, we’ve already had a closing meeting’ sort of idea. She said ‘I’d really like you to focus on the management commentary, OFR type stuff and two other points’ and actually where I make the biggest difference, to be honest, is on the review of that commentary... Does it make sense? Does it fit the business? ...as opposed to they’ve done the checklists on disclosure and such like. (B4P6)

The senior Big Four partner who had perhaps the most radical views on the need for robust assurance on management commentary linked
to more business-orientated corporate reporting, had strong views on regulation.

*I think regulation has a danger of taking the thinking out of audits. Then the audit becomes an exercise in regulatory compliance and is much more focused on saying ‘OK I am doing this audit and I need to do it keeping in the back of my mind that I am going to be reviewed by the AIU and PCAOB and so I would be focused and my team will be focused on ensuring that every ‘i’ is dotted, ...and so on’. The way that we are regulated is too much form over substance. It is a regulatory compliance exercise rather than a real thinking audit.* (B4P11)

Thus this auditor’s vision of the audit is of a much more cerebral and reflective product consistent with his view that more relevant and less compliance driven corporate reporting, would necessarily imply less process-driven audit.

*I think that business reporting should be made more relevant so it does become a tool of communication with the market. As a result the assurance I would give on that business report would become relevant for the market.* (B4P11)

The suggestion here is that present audit methodologies are inadequate for the envisaged integrated corporate reporting and assurance. Generalising, more judgemental and evaluative corporate reporting implies a similar style of assurance. This partner also commented on the general implications for external audit of what he saw as regulatory excess.

*I essentially have to approach the audit from two aspects. I have people who are responsible for making sure that we do an absolutely
first rate audit from a regulatory point of view in terms of what the regulators will be looking for if they come and review it and effectively in parallel what I regard as being required of me as an audit partner in terms of identifying and managing the risks as I see them. So it is almost as if there are two simultaneous audits going on. I don’t know whether anyone else has expressed it like that. (B4P11)

No one else did but the sentiments expressed are certainly consistent with other comments. In summary, while many auditors were supportive of process-based assurance of management commentary, it is also suggested that management commentary assurance might facilitate, or indeed require, more cerebral assurance.

Auditor skills and other issues

The other two related issues on which comments were invited in the questionnaire were concerned with the commercial experience of audit staff and the level of substantive testing. There was much less comment on these topics and so the issues were not consciously explored in the interviews.

A few auditors took issue with the premise that auditors were too inexperienced commercially; either on the grounds that there was a good mix of experience and expertise in audit teams appropriate to the complexity of particular aspects of the audit or that partners or higher level staff did have commercial experience. The following views are illustrative of questionnaire respondents’ views:

Audit teams are structured such that ‘junior’ staff members deal with less risky areas. (Questionnaire comment)

Key to audit quality is partner leadership. Partners have commercial experience and a risk-focus, which should steer the
Audit towards the risky areas. Audit staff may focus on less risky areas or substantively testing the numbers underlying the key judgements. (Questionnaire comment)

More generally, however, while questionnaire respondents acknowledged the suggestion that staff lacked commercial experience, there were mitigating factors such as training, staff mixes within firms and the high quality of audit staff.

Agreed, but the solution is to invest more in staff development and training which will lead to higher fees which companies will resist. There is a balance. Also where someone needs to audit bank, fixed assets, share capital, etc. there is no real need for a high level of commercial knowledge. Through a risk-based audit, much of the commercial knowledge as accumulated by the manager and partner can be better utilised. (Questionnaire comment)

To a point this is valid, however audit staff are not the individuals making the judgements and again economics play a part. Users will not pay for the level of expertise they suggest is necessary. Audit staff are generally bright, motivated and well able to deal with the issues they are faced with. (Questionnaire comment)

These comments and others highlight the potential costs of an audit model dependent on more commercially aware staff at even relatively junior levels and also that in an ideal world auditors would have more commercial experience. Generalising, it appears that while junior staff may be inexperienced, this is sustainable as some audit work is relatively low risk and as junior staff benefit from the guidance of partners and more experienced staff. While the present model appears fit for purpose given existing audit arrangements, widening assurance to include, for example, management commentary, may make some reappraisal of firm
staffing structures appropriate. One questionnaire respondent juxtaposed the lack of commercial experience with audit firms as training entities.

The audit market is a learning environment training many of the accountants and financial leaders of the future. As a result some work must be carried out by inexperienced staff. In most cases more experienced staff will bring greater commerciality through briefing and review. People take up audit careers to get commercial experience; they don’t get commercial experience to become an auditor. (Questionnaire comment)

One or two questionnaire respondents, while agreeing that audit staff were too commercially inexperienced, linked this, arguably unfairly, with a perceived excessive emphasis on rules and regulations.

This also is the result of increased regulation – you don’t need the brain of Euclid to follow rules – especially when they are ‘clarified’. (Questionnaire comment)

There was relatively little comment by questionnaire respondents on the suggestion that audit involved too little substantive testing. While some agreed with the proposition, most did not, emphasising that substantive testing was often ineffective particularly within large or complex organisations. One respondent interestingly linked developments in auditing standards to increased substantive testing.

This would have been true ten years ago but the new ISAs now prescribe a minimum level of substantive testing. (Questionnaire comment)
Summary

This chapter has explored the emphases placed on process, rules and judgement in contemporary auditing. The principal findings are:

• The questionnaire results suggest that auditors are broadly neutral as to whether the recent effects of regulation on audit practice (in fact or as perceived by users) have been beneficial or not. There is, however, wide diversity of view with strong views at both ends of the opinion spectrum.

• Questionnaire respondents were invited to comment on three matters with audit quality implications highlighted by users at the first research stage. Of these, the relative emphases placed on process, rules and judgement in auditing attracted the most comment, and so this was also addressed in the interviews. Despite the relative balance of views held by questionnaire respondents regarding the related matter of the impact of regulation, the most commonly expressed perception was of an audit environment with decreasing scope for exercising professional judgement.

• There are some negative perceptions of the AIU but this is juxtaposed with appreciation of the difficulties in monitoring audit quality. The apparent equation of quality with regulatory compliance and the effort and time spent in preparing audit files for possible inspection appear to be particular grievances. There is some commendation for what is perceived as the embedding of greater judgement in both recently revised ISAs and the work of the AIU. The stress placed by many auditors on judgement contrasts with current concerns about insufficient exercise of auditor scepticism.

• There is some hint, of non-regulatory reasons, for greater emphasis on process including increasing reliance on information technology. While the implications of process and regulation for management
commentary assurance were not explored specifically, such a change in the scope of assurance might facilitate more emphasis on judgement.

• Other issues with implications for audit quality on which questionnaire survey respondents were invited to comment included the commercial (in)experience of audit staff and the emphasis placed on substantive testing. There was relatively little comment on the latter matter but the perception that over-reliance on substantive testing is often ineffective was expressed. While there are various perspectives on the commercial (in)experience of audit staff, widening the scope of audit assurance to include management commentary might make revision of accepted audit firm staffing models appropriate.
This chapter is concerned with audit reporting. Comparisons are drawn, where appropriate, with the first stage results obtained when the issue was explored with users. The chapter discusses auditors’ perceptions of the usefulness of existing audit reports as well as their inadequacies and ways by which these might be enhanced. The technical feasibility of enhancing audit reports, the boundary and overlaps between audit and corporate reporting, and audit reports on management commentary are then explored.

Audit report usefulness

The survey aimed to elicit perceptions on the usefulness of existing audit reports. The results are shown in Table 7.1

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Big Four</th>
<th>Non-Big Four</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
</tr>
<tr>
<td>The perceived usefulness of external audit reports to users</td>
<td>2.25</td>
<td>0.98</td>
<td>2.18</td>
</tr>
</tbody>
</table>

Notes:
There are no significant differences between mean scores awarded by Big Four and non-Big Four auditors.

Scale: 1 = Very useful      2 = Useful      3 = Neutral      4 = Not very useful      5 = Useless

Auditors generally appear to believe that audit reports are useful to users. Around 75% of respondents indicated a belief that current audit reports were either ‘useful’ (60%) or ‘very useful’ (15%) to users.
Around 15% of auditors were neutral on the issue while only a small minority signalled negative views.

At the first research stage both investors and non-investor users were asked the same question about audit report usefulness (see Fraser et al., 2010, p.138). The results for auditors are significantly different to those for investors (at 5%) and for non-investor users (at 1%). Auditors view audit report usefulness as significantly greater than either investors or non-investors. The responses of both investor and non-investor users could be characterised generally as mildly negative, with mean scores of 3.09 (investors) and 3.04 (non-investors). The views of the key fund manager and analyst constituency were particularly negative scoring this question with a mean of only 3.35. Thus while 36% of investors (75% of auditors) believed that audit reports were ‘useful’ or better, 37% of investors (7% of auditors) indicated that they were ‘not very useful’ or worse. Fourteen percent of investors indicated that existing audit reports were ‘useless’. A key auditor-investor difference is the very significant proportion of investors holding clearly negative views about audit report usefulness.

While the interviews revealed a wide variety of views on audit report usefulness, they reinforced the questionnaire results as to the relative views of auditors and users, and the relative distaste of auditors for radical report change. The following subsections discuss the various themes which emerged from the interviews, drawing also on additional comments made by questionnaire respondents.

**Standard audit reports**

The existing audit report is regarded positively by auditors on the basis it signals that an external audit has been carried out in accordance to certain quality standards. The following two comments by Big Four partners essentially articulate this view:
It's a long and dull bit of boilerplate... and I guess doesn't tell the investor very much. Part of me says it actually does tell the investor something... it tells them someone has actually been through the whole thing and the chances are it complies with the relevant accounting standards... (B4P5)

I would say that to the majority of people the audit report and the set of accounts ticks a box. It says: Has it been audited? Have we got a clean opinion? If so, that is all we want to know. That is my maybe slightly naive view based on the contact I have with people. A lot of people still view the audit as a necessary evil – to get that stamp in the box saying 'we [sic] have been audited by a reputable firm with a good name' and move on. (NB4P8)

Although the first of these quotes fails to endorse current audit reports wholeheartedly, both visualise the audit report as rather like, as another interviewee put it, an ‘MOT’, an opinion which appears common to many auditors. The last auditor quoted related his comments to the true and fair view:

\[
\text{In a set of financials... you have an overall opinion which is either agreed as true and fair or, less commonly, disagreed and therefore qualified. (NB4P8)}
\]

The general and non-precise nature of the ‘true and fair’ view was emphasised by other interviewees; not least as a response to users who articulate a desire for more detailed reports incorporating, for example, key judgements made by auditors or their views on critical aspects of the financial statements. One Big Four partner, responding to the wish of users to see more of the ‘messiness’ inherent in the ‘true and fair’ audit opinion, stated:
That comes back to the perception gap; if you read it, it says it gives you a true and fair view, it doesn't say it gives you an accurate view, it doesn't give you a 100% complete view... (B4P9)

The arguments of those favouring existing audit reports, or something similar, reflect investors’ comments at the first research stage to the effect that the simple fact of financial statements having been audited was valuable; ‘a set of accounts signed off by the auditors is a valuable thing for me a shareholder’ was one comment made by a fund manager. Similarly, a Big Four partner emphasised the value standard audit reports added to investors and suggested that it might be difficult to extend this in a way that would be useful to users generally.

We add a lot of value to investors; we give the market the confidence that it needs to be able to transact of a set of numbers that reports historic performance. What some users will want value from is very specific to their individual needs. For example, a sell-side analyst will have very different requirements than a buy-side analyst. It is almost impossible to see that we could write something that would meet all of the users’ requirements. (B4P7)

Inadequacies and enhancement

While most auditors appear to hold strongly positive views about the adequacy of existing reports, the interviews revealed some strongly-held opinions as to their inadequacy. Interviewees were more negative about existing reports, and more positively disposed to possible change, than most survey respondents. A partner of a larger non-Big Four firm articulated this in terms of the limitations of the standard audit opinion.

Obviously there is a range as to what true and fair might mean, but essentially we are asked to express a binary opinion and in
expressing that binary opinion we have to conform exactly with a predetermined set of words. So nobody who reads it can understand what has gone into getting to a position where those accounts will meet the true and fair opinion or fail it. Nobody knows whether I have started with a client that has entrenched views that I do not agree with and I have fundamentally had a battle with to get to a position that I'm comfortable with – and might be only just comfortable with – or whether I've got a client who believes absolutely in full, frank and fair disclosure and I haven't had a problem with them at all... you have two businesses in very, very different states covered by exactly the same wording and therefore of no use in the richness of the understanding of that organisation to any user whatsoever. (NB4P5)

This comment suggests that while the audit report may be analogous to an 'MOT' or a 'kite-mark', it fails to distinguish between cases where the minimum standard is barely met and those where it is surpassed easily. Other comments made the same point differently, focusing on the opaqueness of the process of determining the audit opinion.

It's a really interesting debate as to how we can make the audit more valuable to investors. I think it is quite sad that they only see the one page, because behind that one page there is so much work and so much dialogue... it's actually a shame that they don't see that because if they did I think that there would be a lot more assurance that people would value. When the relationship goes well, boards and audit committees really do see the value in the audit. Does that get out to the investor community? – probably not as much as it should. (B4P8)

I think that it [i.e. audit reporting] is a wasted opportunity at the moment... I am not talking about the work that has gone into
it but about the actual report... What is the point of spending millions and millions of pounds to have something that is just a form of words? (NB4P1)

Thus many auditors recognise audit reports as inadequate. The first research stage established that users favoured responding to such inadequacies by including more entity-specific information, either about key judgements underpinning the financial statements or in terms of the audit process. While many auditors are also sympathetic to enhancing audit reports by such means, other auditors suggested more generic approaches.

Enhancing audit reports: Generic approaches

Two suggested ways of improving audit reports generically are, first, shorter, more concise reports, or, second, longer audit reports but of a still generic character. Negative comment by questionnaire respondents, relating to audit report length, included:

The longer the report, the less useful it is. Better to have clear, concise reporting – what has/has not been subject to ‘audit’. (Questionnaire comment)

At the moment the audit report has evolved into a cumbersome two page opinion that spends more effort pointing out roles and responsibilities than on findings and conclusions. This balance needs to be re-addressed. (Questionnaire comment)

The second of these comments articulates the most convincing argument in favour of shorter reports. Contemporary reports, while quite lengthy, reiterate generic descriptions of roles and responsibilities rather than report on key aspects of the audit reported on. It is difficult,
however, to reconcile more concise audit reports with such an emphasis; disclosing entity-specific information probably implies longer reports. Conceptualising the audit report essentially as an ‘MOT’ or insurance certificate is consistent with concise audit reports giving a simple and unambiguous message and this certainly reflect the views of many auditors.

*Do you [i.e. the user] really want the explanation? [of audit judgements and so on]... Well, actually what you want to do is to audit it yourself... That is the logical extension. It is not enough for me as an auditor to tell you that my professional judgement is that it is appropriate and that it is a true and fair view. You don't actually believe me.* (B4P9)

*John Griffith Jones, the Chairman of KPMG did the Aileen Beattie memorial lecture and he talked about a kite mark – I thought there was a lot of appeal in that although it ended up that we didn't go very far with it because we got into the crisis and it was the wrong time to try and simplify things... but we actually said ‘instead of all this boilerplate which nobody reads, lets get the equivalent of your red triangle type stuff on toys... you just need a mark that says ‘its okay. I'm not going to give you all the caveats but... use these numbers for whatever analysis you want to do’. (B4P6)*

These views, expressed by Big Four partners, reflect a view that is dismissive of entity-specific reports, instead arguing for the reasonableness of the audit process and the work underpinning the audit opinion remaining invisible to users. The following questionnaire comment represents an intermediate view advocating longer audit reports but of a continuing generic, rather than entity-specific, character.
While the audit report is standard wording it is basically a disclosure, with the opinion having very prescribed use. Therefore, to the informed reader, it has a very clear meaning. It may be that the meaning should be clearer to everyone. (Questionnaire comment)

This view suggests past arguments for greater user ‘education’ as to the meaning of the ‘true and fair’ audit opinion similar to that underpinning the expanded audit reports first introduced in the UK in 1993, which aimed to reduce the ‘expectation gap’ and replace the very brief audit reports which had previously been standard practice. Evidence from the present research and elsewhere, however, suggests that initiatives aimed at enhancing the usefulness of audit reports by revising their generic rubric, are unlikely to satisfy user expectations.

Entity-specific audit reports

In terms of how auditors could usefully ‘say more’, one of the bolder comments was that of a partner of a larger non-Big Four firm with Big Four experience:

...a report of the audit process, what we started with, the information that management presented for audit, what we considered a risk, and how those risks were subsequently resolved through discussion and with management, what issues we disagreed with and the quantification of those issues which remain unresolved but didn’t affect our binary opinion... a very different audit environment... management’s reaction would be that they would not have that because anything that even smacks of non-compliance, or non-adjusted error, is going to be seized upon... the negative effect of that is completely out of proportion with the positive effects of giving qualitative analysis in an audit opinion. I think auditors
are going to have to move towards some analysis of; firstly, the process by which financial information is given in the annual report, secondly, the controls over that financial information and, thirdly, some analysis of risk... that’s where we have to go if we’re going to be useful to the user community. (NB4P5)

This view stands at one end of the opinion spectrum; other auditors appreciated the need for change but were more pessimistic about the practical possibilities. The following quotes highlight many auditors’ desire to say more juxtaposed with two major concerns, difficulties with management and litigation implications.

I think most audit firms would love to be able to say more in the public domain but it is extremely difficult to say anything which isn’t an audit qualification about controls which management wouldn’t take umbrage at. (NB4P6)

Litigation is seen as a particular obstacle.

I suppose with my risk management hat on, it would worry me if we had to say things in our audit report that were company specific if they couldn’t be backed up 100% by our findings and robust audit evidence – a lot of the things that you come across when you’re auditing are, I suppose, persuasive rather than conclusive. (NB4P7)

The next sub-section considers the litigation issue in detail.

**Litigation**

The litigation implications were particularly pinpointed in the context of whether it might be feasible to disseminate auditors’ internal reporting to audit committees publicly. More generally, this is concerned
with the ‘to whom’ of audit reporting; is it possible for reports which presently are the preserve of company insiders to be made available publicly? One senior Big Four partner stated that:

At the moment when we report to audit committees we have a framework which is very clearly defined and tied into our responsibilities under current auditing standards in reporting to audit committees. I think if that was to be more widely disseminated in the current legal environment you would probably find some very heavy caveats brought in and probably our advisors would say if we went down that path we would have to rephrase and re-jig the report if it was going to a wider audience. At the moment there is very open dialogue with the audit committee... my worry would be if that starts to become more widely available for others to look at, it would (a) be watered down and (b) I think it would have some heavy caveats. (B4P12)

Another Big Four partner was enthusiastic about such wider reporting but, like other auditors, was conscious of the subjective nature of much of what was presently reported internally.

If we put this into the external marketplace there would be a lot of discussion between management and ourselves to ensure we got our facts right because we’re only spending a limited amount of time doing our work... but, that said, if audit committee documents became public that would be hugely enlightening... The question then would be where would that go from a litigation perspective? ...I don’t see why we couldn’t, necessarily, as long as there was some way of protecting us as audit firms on what we said because a lot of it is just views and judgements... if I look at our audit committee documents a lot of it talks about the areas of judgement... so, for example, if there is a range of appropriate treatments, but if we
forced management to put those range of appropriate treatments into the financial statements and say in the audit report ‘please refer to page X of the financial statements for this key point of discussion between management and the auditors...’. (B4P8)

The key point highlighted here is that there is no obvious technical reason why alternative audit reporting models cannot be implemented; the barriers are perceived as non-technical. Progressing both management commentary and more general audit reporting may require revision of the current liability framework. Auditors’ views on this contrast with a view (see chapter nine) that a framework for limitation of liability exists but that auditors have chosen not to utilise this.

**Interpretive abilities of users**

Concerns about more informative reporting are not restricted to litigation. There are concerns about the interpretive abilities of report users and about the relative domains of auditors and management regarding judgemental matters.

*Generally we like to try and write those [audit committee communications] as frankly and straightforwardly as possible because it is part of our communication with our client and that needs to be very direct. Shareholders may... take them completely out of context.* (B4P5)

*What could one say apart from something reasonably high level? The reality is that with the more complex businesses the judgements are so complex that typically there will be four audit committee meetings lasting three hours each where these things are considered... trying to distil all of that into a written form that is useful, I think would be difficult.* (B4P10)
The point here is that it would be difficult to use communication with audit committees as a basis for public audit reports. A Big-Four partner suggested interpretive difficulties on the part of users.

*I think care would have to be exercised if we were to go in that direction because at the moment the psychology of people looking at audit reports is ‘is it clean? is it a clean audit report?’ if you start introducing areas of judgement and shades of grey then people would need to understand that what you’re not qualifying exactly and understanding that financial statements have many areas of judgement and in some cases there isn’t a right answer...we have a lot of companies in the real estate sector and a lot of companies that have valuations of portfolios. You can have different approaches on values which are valid because they are within a range which the financial reporting standards agree is reasonable and highlighting those as areas of judgement is fine as long as it’s taken the right way. I would worry about the analysts having this 10 minutes read of the financial statements before the 7 o’clock call to their traders, looking at each other saying ‘they’ve really undervalued this because the auditors say they could have valued it higher or lower’. (B4P2)

These reflections are consistent with the view that it is sufficient for users to receive unembellished true and fair opinions or that audit reports might be revised in a generic ‘educational sense’. While all these views differ in detail – one audit partner somewhat paradoxically suggested that he didn’t ‘think the world really knows what true and fair means’ – they have in common an underlying assumption that users are unable to appreciate the fine nuances of accounting or auditing judgement. To extend the ‘MOT’ analogy, this is similar to the way by which most motorists may not be capable technically of appreciating the mechanical judgements which determines the ‘MOT’ pass or fail.
While such an underlying assumption may be plausible, it invites challenge given opinion favouring more informative reporting. A related reservation highlighted by one Big Four partner was that the current method of injecting more colour in audit reports, an 'emphasis of matter', automatically carried negative connotations.

In the context of the current standards we can use an emphasis of matter paragraph ...where we feel that management hasn't already explained sufficiently or explained its parameters sufficiently. But they are always viewed relatively negatively, relatively might not be the right word, they are always viewed negatively. (B4P7)

One slant on this may be that more educational initiatives aimed at users by auditors or professional bodies may be necessary, although such past initiatives have not been notably successful.

**Technical feasibility of enhancing audit reports**

While many issues surrounding the enhancement of audit reports are non-technical, a second survey question on audit reports elicited views on the technical feasibility of reporting on several issues which might arguably result in more useful reporting. The results are shown in Table 7.2.
Table 7.2  Perceptions of the technical feasibility of audit reports covering various specific issues

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>Big Four</th>
<th>Non-Big Four</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M  SD</td>
<td>M  SD</td>
<td>M  SD</td>
</tr>
<tr>
<td>Risks and uncertainties faced by the entity</td>
<td>2.51 0.97</td>
<td>2.45 0.94</td>
<td>2.61 1.02</td>
</tr>
<tr>
<td>Reference in reports to specific audit issues (especially those of a judgemental or sensitive nature) and their resolution</td>
<td>2.52 1.20</td>
<td>2.58 1.29</td>
<td>2.41 1.05</td>
</tr>
<tr>
<td>Information on alternative accounting treatments and reasons for the chosen treatment[1]</td>
<td>2.36 1.04</td>
<td>2.45 1.03</td>
<td>2.20 1.05</td>
</tr>
<tr>
<td>Management competency[1]</td>
<td>3.94 0.99</td>
<td>4.08 0.96</td>
<td>3.72 1.03</td>
</tr>
<tr>
<td>The adequacy of the entity infrastructure</td>
<td>3.28 1.03</td>
<td>3.31 1.09</td>
<td>3.24 0.92</td>
</tr>
</tbody>
</table>

Notes:
1 Significant differences at 10% between mean scores awarded by Big Four and non-Big Four auditors.

Scale: 1= Very feasible  2= Feasible    3= Neutral    4= Unfeasible    5= Very unfeasible

Table 7.2 shows all statistically significant differences between the mean scores awarded by Big Four and non-Big Four auditors. These results indicate little enthusiasm for audit reporting on the ‘adequacy of the entity infrastructure’ and clearly negative views regarding reporting on ‘management competency’. Table 7.2, however, does indicate reasonable support for the view that reporting on the other three issues – risks and uncertainties, judgemental or sensitive audit issues and alternative accounting treatments – would be technically feasible. In each of these three cases, around 66% of responding auditors indicated a view that reporting was ‘feasible’ or ‘very feasible’ while substantial minorities, between 18% and 27%, signalled negative views. Thus a majority of auditors appear to believe that enhancing audit reports by these means may be feasible.

At the first research stage, it was considered inappropriate to ask users about the technical feasibility of enhancing reporting. Investors,
however, were asked for their views as to the usefulness of reporting on the first three issues highlighted in Table 7.2 with non-investors being requested for their views on ‘risks and uncertainties’ and ‘judgemental and sensitive matters’ only (Fraser et al., 2010, p.143). The usefulness of reporting on each of the three issues was assessed as ‘very useful’ or ‘useful’ by at least 60% of responding investors while reporting on the two issues put to non-investor users was assessed as ‘useful’ or better by at least 77% of respondents in each case. While the results for auditors and users are not directly comparable they suggest that the three issues highlighted are both regarded favourably by users in terms of audit report enhancement and as technically feasible by auditors. The issues were explored with auditors in the interviews when, as noted previously, it became apparent that the primary obstacles to enhancing audit are largely non-technical.

### Reporting by auditors or by management?

Several auditors emphasised that it was not audit but corporate reporting which required enhancement. Comments by questionnaire respondents included:

*Improve the annual report – give more transparency and disclosure. As the annual report improves, so too will the usefulness of the audit report... The annual report is key to enhancing usefulness.* (Questionnaire comment)

*You cannot enhance the usefulness of audit reports without first enhancing the usefulness and relevance of business reporting as a whole. In other words, you should not rely on the audit report to ameliorate the significant short comings of the present day business report.* (Questionnaire comment)
Financial statements prepared under IFRS are far too detailed and complicated for even qualified readers to understand in most cases. The usefulness of marginal changes to the audit opinion is a drop in the ocean by comparison. (Questionnaire comment)

These thought-provoking comments echo formal initiatives such as the recent ICAS publication *Making Corporate Reports Readable* (ICAS, 2010a) and comments made by auditors suggesting such developments as a more cohesive corporate reporting and assurance package and commentary by auditors on the entity’s own management commentary. Such views may suggest a degree of indeterminacy as to the management-auditor interface and one of the most generally held reservations about more detailed audit reports was the perceived danger of conflating the jurisdictions of auditors and management.

*I think what's important to bear in mind is that the judgements and assumptions are management’s and the auditor is forming an opinion as to whether these are reasonable. So, if more visibility over the assumptions and judgements that management have taken is considered desirable then it should be management that's providing that information and then the auditor is saying effectively that those judgements and assumptions are acceptable for the purposes of preparing the financial statements.* (B4P10)

*My own personal thoughts are that we are getting two things mixed up. One is the responsibility of management to articulate some of the shades of grey that exist in the numbers that they have produced – it should not be the auditor’s responsibility to educate the users of financial statements… At the end of the day the auditor’s responsibility is to say that the financial numbers in the financial statements provide a true and fair view. So I think that we have strayed from what is management’s responsibility,*
and what is the auditor’s responsibility, and we get this push back from the users. I think partly it is a frustration with financial statements as a whole because they find them difficult to use. And they don’t get what they want from management and therefore the default is ‘we pay all this money to the auditors – why don’t the auditors tell us that?’ And I think we have strayed into some really interesting moral predicaments where actually the people that investors are relying on to provide them with information that is relevant to their view of the company is a set of third party individuals and not the company themselves. (B4P7)

An alternative perspective to that highlighted in the above quotes, however, is that the complexities of financial reporting are now such as to make entity-specific audit reporting appropriate. This is consistent with the view that IFRS-based financial statements are difficult for users to understand. A more detailed reporting model might distinguish between management and auditor jurisdictions, with the former responsible for communicating the key accounting judgements and auditors a view as to their appropriateness. This is essentially what the French model attempts to do. One Big Four partner expressed the investor perspective relevant to such models somewhat irreverently as ‘What the investors really want to know, I suspect, is ‘Are these guys racy or are they at the other end of the spectrum?’ (B4P5). This auditor was careful not to dismiss the step-change for audit reporting which accommodating such investor concerns would involve.

I think there is a risk of being seen as a profession as dismissing this stuff as being too difficult... there should be a debate about it. I think we need to explore what real value would come out of it and what the risks are to us and what the practicalities are before saying no. (B4P5)
While any external audit ‘provides investors with information that is relevant to their view of the company’, complex judgement-grounded corporate reporting may blur respective management and auditor responsibilities. Many users believe that more effective communication of ‘colour’ or of ‘shades of grey’ is needed. Management commentary may be strategically important here; some auditors favour more effective management commentary which the auditors would then assent to generically.

*It depends on whether you want the auditors to do the reporting that gives them the grey areas or whether it’s actually a quality of management commentary. If you’ve got a management commentary that actually talks through the grey, we shouldn’t need to do anything... what you want to do in my view is get better shades of grey from the company than from me. I need to say ‘actually that’s a reasonable picture of grey they’ve given*. (B4P6)

More radical opinion argues, however, that auditors should be commenting on management commentary; in effect, writing their own commentary on that of management. Given the possible confusion of auditor and management jurisdictions many auditors might view this as undesirable. One young non-Big Four director stated:

*Oh wow, that is dangerous. You are walking a fine line – on one hand audit is regulated on the ethics and independence side and then you have us writing a management commentary.* (NB4D1)

However, a partner from one of the larger non-Big Four firms welcomed the benefits which such an adventurous approach might bring:

*That would be an interesting development. If you think about the long-term attractiveness of audit as a profession this is something*
which I think could actually help because ...it has become too procedural and too checklist based. The auditing profession has always attracted and retained good people ...if it could be much more like a due diligence or Long Form report there is potentially mileage in that. (NB4P6)

Perhaps more radical still is the view, held strongly by one senior Big Four partner, that the audit reporting issue was less important than reforming the audit itself or, even, packaging corporate reporting and assurance holistically. The respective reporting responsibilities of auditors and management required simultaneous consideration:

*I think the value of audit reporting is just reflective of the value of accounts. Accounts aren’t particularly valuable at the moment and so the assurance that is expressed on these isn’t very valuable either. I can see that there is an issue about how relevant and valuable the audit report is, but ...I don’t think that is going to be addressed until you look at business reporting. The limitations of the audit report are a function of what we are reporting on.* (B4P11)

These views reflect this auditor’s view, cited in chapter four, that a much more elaborate assessment of the future by directors with associated in-depth commentary by auditors, and ‘safe-harbours’ for both directors and auditors, was required. Questions of whether or not auditors might usefully comment on the corporate management commentary and the efficacy of corporate reporting as a whole have relevance to the third question on audit reporting which was specifically concerned with reporting on management commentary.
Reporting on management commentary

The objective of the third and final question on audit reporting was to elicit views as to the appropriateness of various methods of communicating assurance on management commentary. The results are shown in Table 7.3.

Table 7.3 Appropriateness of various methods of communicating assurance on management commentary

<table>
<thead>
<tr>
<th>Method</th>
<th>Total</th>
<th>Big Four</th>
<th>Non-Big Four</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M  SD</td>
<td>M  SD</td>
<td>M  SD</td>
</tr>
<tr>
<td>The standard audit report(^1)</td>
<td>3.14 1.19</td>
<td>3.12 1.22</td>
<td>3.17 1.15</td>
</tr>
<tr>
<td>A longer entity specific report on the corporate report as a whole(^1)</td>
<td>2.83 1.10</td>
<td>2.87 1.09</td>
<td>2.77 1.13</td>
</tr>
<tr>
<td>A standard audit report specifically on the management commentary(^2)</td>
<td>2.82 1.03</td>
<td>2.83 1.11</td>
<td>2.81 0.90</td>
</tr>
<tr>
<td>A longer entity specific report on the management commentary(^3)</td>
<td>3.13 1.09</td>
<td>3.21 1.04</td>
<td>3.00 1.16</td>
</tr>
</tbody>
</table>

Notes:
1 Significant difference at 1% between mean scores awarded by auditors and those awarded by investors in stage 1 of the research project (investors score more highly than auditors).
2 Significant difference at 5% between mean scores awarded by auditors and those awarded by investors in stage 1 of the research project (auditors score more highly than investors).
3 No significant differences between mean scores awarded by Big Four and non-Big Four auditors.

Scale: 1= Very appropriate  2= Appropriate  3= Neutral  4= Inappropriate  5= Very inappropriate

These results suggest that while generally auditors may be characterised as broadly neutral as regards all these ways of reporting assurance, there is a wide dispersion of view. Thus while substantial proportions of respondents signalled positive views (‘very appropriate’ or ‘appropriate’) about each reporting method (38%, 47%, 48% and 34% respectively in the order reported in Table 7.3), similar proportions indicated negative views (45%, 32%, 27% and 42% respectively). The
two methods which have more support, although not overwhelmingly so, are a longer entity specific report on the corporate report as a whole and a standard audit report specifically on the management commentary. Perhaps what is most obvious is not the popularity of these two methods but the lack of enthusiasm for the remaining options – opining on management commentary in ‘true and fair’ terms and commenting on management’s commentary. There are no significant differences between the views of Big Four and non-big Four auditors.

When the same assurance methods were explored at the first research stage (see Fraser et al., 2010, p.117) investors scored them with means of 2.43, 2.68, 2.93 and 2.95. Table 7.3 details the statistically significant differences in the scores awarded by auditors and investors respectively. The most obvious difference between auditor and user results is in respect of management commentary assurance via the standard audit report. While this method was the most popular choice for investors (53% positive views) it was one of the less popular options for auditors (38% positive views). The lack of appeal to auditors might be explained by greater appreciation of the implications of ‘true and fair’ and by the reluctance of many auditors, as discussed in chapter five, to opine on ‘soft’ management commentary content in these terms.

Comparing the results for auditors and users, for the various issues explored in this chapter, indicates that while users generally have slightly negative views about the usefulness of existing audit reports they prefer this method for communicating management commentary assurance. Auditors, however, generally hold positive views about the usefulness of existing audit reports but view them as relatively unsuitable for communicating assurance on management commentary. The following comment by a non-Big Four director highlights this lack of enthusiasm for reporting on management commentary via the standard audit report.

For me it has to be something that is separate. We work on historical financial information – we don’t work in the future so
if you are going to bring the future in then you have got to have flashing lights, making very clear it is very different. (NB4D1)

Another auditor made the point that while it might be possible to have one report, such a document would require to distinguish clearly between the respective opinions on the ‘front-end’ and ‘back-end’.

*My hunch would be to keep life simple and have one report but the opinion would have to be kept separate from the opinion on the financial statements, which is the back half. In a way that’s what happens at the moment because there is an element concerned with the director’s report and that’s the subject of a separate line in the opinion.* (B4P2)

In terms of how these two putative opinions might be worded one partner suggested that with a split audit report, or opinion:

*...you would have a true and fair report on the financials as they stand and something less than that – whether it’s a report on process or in terms of we have carried out procedures, a, b, and d or whatever – in respect of the future forecasts, for example.* (NB4P6)

One auditor argued that, once again, the liability issue was critically important.

*The only reason you get the separation issue, frankly, is because of the liability thing. If we could fix that distortion, there is no reason why we couldn’t have a comprehensive report on the financial statements as a whole.* (B4P7)

While there are various perspectives on communicating management commentary assurance, a holistic and integrated resolution of both
audit reporting and corporate reporting issues would dispose of much of the problem. The key to communicating assurance on management commentary may ultimately depend upon resolving the corporate reporting issue.

Summary

This chapter has explored perceptions as to the adequacy of current audit reports and possible means of, and obstacles to, enhancing those. The chapter has also dealt with reporting assurance on management commentary. The main points are:

• Auditors generally hold positive views about the usefulness of existing audit reports. These views contrast with those of users and, in particular, investors, on this issue as identified in the first research stage. A difference between auditor and user constituencies is related to the true and fair view. Whereas many users desire to see something of the detail underpinning the true and fair opinion, many auditors place value on the general nature of ‘truth and fairness’. Such opinions are consistent with the view of audit reporting whereby users’ primary interest is argued to be simply a question of ‘pass’ or ‘fail’ and where the subtle nuances underpinning the audit opinion, remain invisible. It was consistent with this that some auditors interviewed argued for either more concise audit reports or for more generic material of an ‘educational’ nature. An essential supposition of such perspectives is that it remains acceptable for the detail of the audit process to remain invisible to users. Some auditors highlighted what they saw as the danger of users misinterpreting more specific audit reports, with consequent litigious implications.

• The questionnaire results suggest that a majority of auditors believe that it is technically feasible for audit reports to include material on specific audit issues of a judgemental nature, on alternative
accounting treatments, or on risks and uncertainties. Furthermore, some auditors do believe strongly, even passionately, that it is not only possible for audit reports to be enhanced in this way but vital. They cite perceived present deficiencies such as the invisibility of the audit process or the multiple gradations covered presently by the true and fair view, in a manner which reflects much user opinion.

- Obstacles to moves towards more transparent or entity-specific audit reporting are not perceived as primarily technical. Problems envisaged include the anticipated unfavourable reaction of management to more judgement-specific reporting or the conflation of management and auditor responsibilities. The latter appears to be seen as a particularly serious issue and would require consideration as part of any move towards more judgement-specific reporting. The current French model of audit reporting, for example, does demonstrate that it appears possible to deal with this tension.

- Litigation related issues are also seen as a significant obstacle standing in the way of more expansive reporting. A fundamental element of this is that more entity-specific reporting would necessarily imply more ‘soft’ content, persuasive rather than conclusive. The model which auditors currently use for reporting to audit committees could technically be applied to statutory audit reporting – and might be seen, by some auditors as an ideal template for more informative reporting. Putting audit committee documents into the public arena, however, might change the current open and frank nature of auditor-audit committee communication. It seems likely that some significant reformation of the existing auditor liability framework will be required before more entity-specific reporting is regarded as a palatable prospect by significant elements of the audit profession.

- As far as audit reporting specifically on management commentary is concerned, auditors generally are unenthusiastic about reporting in ‘true and fair’ terms or about entity-specific reports focused on
management commentary. These attitudes respectively reflect more fundamental views about the difficulties of providing assurance on management commentary and about the conflation of management and auditor responsibilities. In contrast, however, some auditors are enthusiastic about the prospect of auditors providing their own commentary on management commentary or even about a radical reformation of corporate reporting with associated implications for assurance.
Auditor-investor dialogue was not included within the original research remit. However, as the first stage demonstrated that many investors perceived existing audit reports to be of little value, other possible means of enhancing auditor-investor communications were explored. Several possibilities were highlighted including audit committees and annual general meetings (AGMs). While these suggestions were not universally applauded by investors, with concerns including client confidentiality and auditors colonisation of management’s jurisdiction, investor sentiment might be interpreted as a desire to reinvigorate the links between auditors and shareholders. Some investor views echo the ‘Guidelines for Enhanced Disclosure’ issued by a working group of members of the Global Auditor Investor Dialogue (GAID, 2009) and since endorsed by a number of key user groups. The Audit Quality Forum (AQF) of the Institute of Chartered Accountants in England and Wales (ICAEW) has stated its support for the general principle of shareholder-auditor involvement and has produced specific proposals for managing shareholder questions to auditors (ICAEW, 2005). These were produced against the backdrop of the Australian Companies Act 2001 enhancing the rights of shareholders to question auditors at AGMs. While these ICAEW proposals were less radical than the Australian legislation, they did not result in corresponding UK legislation. It may be, however, that initiatives in respect of auditor-shareholder dialogue carry additional momentum since the recent financial crisis. It is clear (ICAEW, 2005) that the AQF working party did not achieve complete consensus on the issues.

Given this lack of consensus, and the first stage results referred to above, this second research stage investigated auditor views on enhancing
auditor-investor dialogue. More specifically, this chapter covers private auditor-investor meetings, questions to auditors at AGMs, submissions of written questions to auditors and the role of non-executives in enhancing dialogue.

Enhancing auditor-investor dialogue

The questionnaire elicited perceptions as to three possible ways of enhancing auditor-investor dialogue. The results are shown in Table 8.1.

Table 8.1 Auditor views of possible ways of enhancing auditor-investor dialogue

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th></th>
<th>Big Four</th>
<th></th>
<th>Non-Big Four</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
</tr>
<tr>
<td>Facilitate greater questioning of shareholders at AGMs</td>
<td>3.17</td>
<td>1.13</td>
<td>3.21</td>
<td>1.10</td>
<td>3.11</td>
<td>1.18</td>
</tr>
<tr>
<td>Permit shareholders to submit written questions to auditors for response via corporate websites or other means</td>
<td>2.78</td>
<td>1.11</td>
<td>2.70</td>
<td>1.14</td>
<td>2.91</td>
<td>1.06</td>
</tr>
<tr>
<td>Permit shareholders to meet privately with auditors</td>
<td>3.98</td>
<td>0.99</td>
<td>3.99</td>
<td>0.99</td>
<td>3.98</td>
<td>1.01</td>
</tr>
</tbody>
</table>

Notes:
No significant differences between mean scores awarded by Big Four and non-Big Four auditors.

Scale: 1 = Very reasonable  2 = Reasonable  3 = Neutral  4 = Unreasonable  5 = Very unreasonable

These results indicate that none of the three suggestions are viewed enthusiastically by auditors. Most obviously, the suggestion that shareholders should be allowed to meet privately with auditors is regarded very negatively and is viewed as unviable. No less than 76% of respondents scored this option as either ‘unreasonable’ or ‘very unreasonable’. Opinion on the other two options is much more evenly split.
Private auditor-investor meetings

The clear rejection of the suggestion that shareholders should be permitted to meet privately with auditors, is unsurprising given that: the duty to care owed by auditors is to shareholders as a body rather than individually (see ICAEW, 2005); the widely-held view that communications in this area should be characterised by ‘a level playing field’ and legal prohibitions on insider dealing. Comments made by questionnaire respondents emphasised these points.

*Auditors cannot legitimately communicate with shareholders other than as a body. We think that is the proper position.* (Questionnaire comment)

*Communication has to be to all shareholders — very difficult for an auditor to deal privately with an individual shareholder without making him automatically an insider.* (Questionnaire comment)

Private auditor-investor meetings were not, therefore, explored further during the interviews. The other two possibilities highlighted by the questionnaire survey attracted more positive comment.

Questions to auditors at AGMs

Auditors were generally neutral on this issue scoring the postal survey question on this issue with a mean score of 3.17; the standard deviation of 1.13, however, indicates a wide diversity of view. Thirty-six percent and 42% of respondents scored this proposal positively or negatively respectively. The questionnaire elicited both positive and negative comments on this proposal and these are considered here, together with comments made in the interviews. A significant minority of auditors regard the proposal to allow questioning by shareholders at
AGMs positively. The following comment of a questionnaire respondent encapsulates important aspects of the issue.

*I think that it is right that auditors should answer appropriate questions from shareholders as long as confidentiality/ethics are not breached and the answers are provided to shareholders as a whole. Certain questions should always be dealt with by the company, however.* (Questionnaire comment)

This comment highlights, first, the importance of auditors’ responses not breaching the duty of client confidentiality, second, the importance of any information in response to questions being made available to all shareholders and, third, the importance of distinguishing between the spheres of management and auditors. Subject to these caveats, which apply generally to initiatives to enhance auditor-investor dialogue, and not just to the AGM option, there does appear to be support for shareholder questions to auditors at AGMs. These comments indicate widespread concerns about the necessity of information communicated in response to individual shareholders’ questions being made available to all. The following questionnaire response, however, makes clear that this sentiment is not universal:

*Significant shareholders could meet with auditors via the company if they wanted. We should not just facilitate the standard of questions you get at AGMs from uninformed minor shareholders.* (Questionnaire comment)

It is not clear whether or not this respondent believes that information disclosed as a result of the suggested restricted meetings should be available to all investors. The comment, however, highlights a possible incongruence; some consensus that information from auditor questions should be made available to all shareholders juxtaposed with
the existence of one-to-ones and other meetings between company managements and privileged shareholders. Arguably, such one-to-ones make the ‘level playing field’ presumption problematic for company-investor communications (see, for example, the discussion in Holland, 1998). An interesting moral dilemma ensues as to whether different standards should and can be applied to auditor-investor relations; from a corporate governance perspective this appears inconsistent. The restricted access to auditors advocated by the questionnaire respondent quoted above echoes a similar suggestion made by a senior Big Four partner.

*So that you have proper engagement, you could ask the auditor to do a presentation to the shareholders at the AGM or, and I’m talking the listed market here, the auditor goes when you’re doing the analyst presentations, if you use the analyst as the proxy link.* (B4P6)

Client confidentiality and the related issue of ensuring that information divulged by auditors was made available to all did not attract the same level of comment, but the following statement by a non-big Four director is an exception:

*We can’t have discussions with Tom, Dick and Harry when we are holding sensitive information … if we share information with a shareholder and inadvertently pass something that allows them to trade and make a profit then we are going to get our wrists slapped, so you have to put a boundary in there. We engage with a company, we can have interaction with shareholders to a limited extent but we can’t divulge information.* (NB4D1)

What was properly the remit of the auditor and what should be reserved to the company to disclose did attract widespread comment, however, both from questionnaire respondents and interviewees. The
following are just two of a significant number of comments made by questionnaire respondents.

*The auditor is not responsible for the operation of, nor the reporting for, their clients. If questioning focused on audit findings then this would be reasonable but inevitably the questioning would go into operational areas. There is still an ‘expectation gap’ for most ordinary shareholders as to what assurance the audit report covers, i.e. financial and all areas of operation for organisations.* (Questionnaire comment)

*Need to remember that primary responsibility for stewardship of a company rests with the directors and shareholders should therefore deal directly with directors on most, if not all matters of judgement and operation.* (Questionnaire comment)

Similar comments were made in the interviews:

*If shareholders have concerns about the judgements in the accounts then the first place for that conversation must be the people who made those judgements being the directors. I think that there is a slight risk in all of this that you blur the responsibility.* (B4P5)

*I think what it does do is that it changes the perception of the auditor with the shareholders because at least they have an opportunity to ask questions. There is a perception for some shareholders of having a level of connection that otherwise they would not have had... and actually would we really want to be talking to investors? ...not necessarily without management whose responsibility is it to comment on the judgements that management have made.* (B4P7)
These, and similar, comments reiterate the well recognised danger of conflating management and auditor responsibilities and reflect comments about entity-specific audit reports incorporating judgement-centric material. The last auditor quoted, however, highlights the positive effect which a facility allowing access to auditors may have in helping to re-establish historic auditor-shareholder relationships. The Big Four partner commenting here also argued that there might be an opportunity, even a need, for institutional investors to attend more AGMs thus facilitating more effective corporate governance.

_It is a travesty that they [i.e. institutional investors] do not attend AGMs. Now whilst ...they are not the most riveting of sessions ...frankly unless people who have an interest turn up and try to change that, they will never be the corporate governance body that we would like them to be._ (B4P7)

These positive sentiments were juxtaposed with negative comments about AGMs as a forum for auditor-investor dialogue. In addition to the caveats already highlighted, there was comment on the prevalence of less helpful questions, usually from private investors, at AGMs; partly this resulted from the absence of professional investors.

_I think that the large institutions never go there. The small private investors go and you can get some really good penetrating questions from the private investors; you can also get daft ones and so I think that questioning auditors at AGMs is not going to move the debate on. At smaller companies, let’s say AIM companies or the small cap companies, you will sometimes find an investor that has 15% and might come to the AGM, but most boards these days would regard it as their mission to be communicating with these people._ (B4P2)
[Institutional investors] have instant one-to-one access with management so why would they go to the AGM. They don't have to attend the meeting to be able to get an audience. So what you have is you have small investors coming along and using the AGM as a sort of fun day out and asking questions which are not really relevant to the big picture. (B4P11)

Nevertheless this Big Four partner did commend the erstwhile initiative which would have given shareholders power to question auditors at AGMs.

You remember the proposal that never saw the light of day to make auditors available to answer questions at the AGM... I think that would be a starting point. (B4P11)

One auditor suggested that, due to AGMs being constrained by a set agenda, fund managers and other shareholders would benefit more from specifically focused sessions with auditors. Other problems highlighted included the arguably significant cost of providing answers to questions and litigation issues. On the issue of cost, one questionnaire respondent went as far as to suggest that audit costs would be increased significantly. Litigation was highlighted specifically by some questionnaire respondents.

The power to question auditors would require ‘safe harbour’ provisions to avoid auditor liability arising as a result of answers provided at AGMs. If auditors are ‘liable’ for comments made at an AGM then it is unlikely that answers will be anything other than boilerplate. (Questionnaire comment)

The problem is the liability issue which means auditors have to be very careful on communications with other parties. (Questionnaire comment)
One Big Four partner, very much in favour of better communication with shareholders, argued that auditor liability was the fundamental barrier to progress. This requires consideration, as already highlighted by the ICAEW Audit Quality Forum (ICAEW, 2005), in the event of future regulation on the issue; auditor sentiment here reflects liability concerns in relation to audit reports and assurance on management commentary.

**Written questions to auditors**

Submission of written questions to auditors elicited a more positive reaction, leaving aside the problems already highlighted in respect of AGMs, auditors may be relatively receptive to this in that it would facilitate more reflective responses. One non-Big Four partner was negatively disposed towards shareholders’ ability to ask questions ‘cold’ at AGMs because:

> What you wouldn’t want to do is to be asked a question on the spot and have to give an answer because you could get it wrong. It depends on the question but it could be a question on detail that you may not at audit partner level be immediately familiar with. An AGM could be some time after you have signed the accounts. (NB4P8)

Auditors scored the survey question on the submission of written questions to auditors with a mean score of 2.78 suggesting, in general, a mildly positive attitude. The standard deviation of 1.11, however, indicates diverse views and 51% and 29% of respondents, respectively, scored this proposal positively or negatively. One non-Big Four partner suggested that:

> I don’t know whether there could be some mechanism for shareholders to submit questions in advance to auditors so that
at the AGM the auditors could respond to those questions within a framework. Then at least those shareholders interested in more specific details about how the audit was conducted or where the key areas of risk were and what the auditors found when they looked at those areas might have the opportunity to access that information. (NB4P7)

Generally then, this proposal is viewed positively.

Audit committees and other suggestions

Although not incorporated in the questionnaire, the role of audit committees, or non-executives generally, in communicating with shareholders was highlighted specifically by research participants. This reflects investor comment at the first research stage and the Guidelines for Enhanced Disclosure (GAID, 2009). One questionnaire respondent suggested that existing corporate governance structures made other auditor-shareholder communication inappropriate.

The current framework has the non-execs taking some responsibility for oversight of the execs. If this is retained then I am not sure what the auditor is doing seeing investors. If this is to be changed and the auditors take on such a responsibility this would imply a massive change in corporate governance. (Questionnaire comment)

Some auditors emphasised that their duty of care is to the shareholder body and not individuals. The following quotes assert that auditor responsibilities to shareholders are realised through audit committees to whom detailed entity-specific reporting is directed:

In our current legislative framework, our responsibility is to the members but the way we deliver that responsibility is ...through the audit committee and the audit committee as board members,
but with user responsibility to the members, has the responsibility to question us and that's fine. Until we change the fundamentals of who we are reporting to I think we have to carry on reporting through the audit committees. (NB4P5)

Well, we certainly obviously report to the shareholders and we report through the board, typically through an audit committee and the non-execs, as to our assessment on the judgements that management have made and whether we think those judgements are within an appropriate range or not and whether they're consistently applied from year to year. The audit committee and the board are actually shareholders' representatives. (B4P3)

Should information provided to audit committees be made available to individual investors requesting it? One Big Four financial services partner suggested that this might be contingent on the number of investors in a company and the consequent practicalities.

With investment funds, from time to time, we are asked if we are happy for the investors, and there may be only a small number of them, to see our audit committee report and therefore we have to put the protocols in place to enable us to do that... We did have a debate about whether if one investor is asking for this information then shouldn't all. In contrast, in the listed sector you might have 20 large institutions holding 60% of the shares and you will have tens of thousands of people holding the balance. It's impractical to go round all those and have that degree of engagement with shareholders. (B4P2)

There was one suggestion to the effect that shareholders required educating on the representative role of non-executives and another emphasised the potentially educative role of auditor-shareholder
communications which might, for example, inform investors about audit practice generally rather than particular audit issues:

_I think [there is scope for auditor-investor dialogue] particularly at an institutional level, e.g. in the UK market Legal and General own 3% of everybody so I think at the level of those bigger investors there should be more dialogue than there is. I think in the first instance it would be at the level of what an audit is today... even in my career that has changed dramatically. I would do it through ICAS or ICAEW._ (B4P5)

Such views, emphasising generically-orientated communications, reflect the significant body of opinion opposed to awarding shareholders the power to question auditors on, or receive information on, audit-specific issues. Dialogue, as envisaged here, echoes past trends towards ever-longer, but still generic, audit reports. A suggestion that ‘shareholder representative groups meet audit firms on an industry by industry basis’ might also be described as broadly educational in approach. Such previous initiatives have not been notably successful in closing the audit expectations gap. Opinion favouring dialogue through audit committees or educational initiatives may be viewed as relatively conservative. In contrast, the following view is at the radical end of the spectrum.

_The best form of communication as a first step would be for auditors to provide a commentary on the management commentary._
(Questionnaire comment)

This comment, along with many others, highlights that the various research issues are not mutually exclusive. Some auditors recognised the desirability of enhanced auditor-shareholder communication but had difficulty in envisaging how this might be achieved. It was notable, however, that some auditors with reservations about auditor-investor
dialogue nevertheless had a sense of its appropriateness in principle. One senior Big Four partner in the final stage of his career who was unconvinced about how users might benefit from more auditor-investor communication acknowledged that:

*It’s always struck me as being slightly odd that people don’t stand up and ask us what we think about this or that.* (B4P1)

**Summary**

This chapter has explored perceptions on enhancing auditor-shareholder dialogue. The principal conclusions are:

- There is a significant, although not overwhelming, strand of auditor opinion in favour of enhanced dialogue with shareholders. Three possibilities by which auditor-shareholder dialogue might be enhanced were proposed to questionnaire respondents. One of these, that auditors should be allowed to meet privately with shareholders, was rejected decisively. This reflects concerns that any enhanced communication between auditors and shareholders should ensure that disseminated information flows to all, rather than selected, shareholders and about litigation issues generally. Of the other two possibilities, auditors generally are neutral on the AGM option but at least mildly positive on the submission of written questions. These views reflect issues such as the prominence of questions from uniformed private shareholders at AGMs and, particularly, a lack of opportunity for auditors to reflect before responding at AGMs.

- It is apparent that in the context of existing corporate governance structures audit committees are viewed as a significant, and by some, the primary means by which to enhance auditor-shareholder communications. In contrast, more radical possibilities include linking auditor-shareholder engagement with analyst presentations.
and auditors producing their own commentaries on those of management.

• Whatever means of enhancing auditor-shareholder communication might be adopted auditors are concerned to ensure auditor and management domains remain distinct. This is consistent with the significant strand of opinion opposed to auditors opining specifically on entity-specific matters whether in audit reports or elsewhere.

• Some auditors opposed to enhanced communication and dialogue of a specific character did envisage more generic and educative communication; for example on the nature of contemporary auditing practice. It is doubtful whether initiatives of this nature will satisfy user appetite for more information.

• The most general auditor view on auditor-shareholder dialogue appears to be that engagement is appropriate in principle, despite perceived obstacles to realising this. In this respect, the dialogue issue has much in common with that concerning more informative audit reports.
The preceding four chapters have addressed auditors’ views on the research questions. Although not part of the original proposal, it was considered appropriate to discuss the issues with representatives of some of the principal bodies concerned with regulating auditors. Four interviews took place subsequent to those with auditors; the auditor interviews, therefore, moderated and informed the discussions with regulators. The regulatory bodies included the UK Financial Reporting Council (FRC), the International Auditing and Assurance Standards Board (IAASB) and the Financial Services Agency (FSA). A recent UK government proposal (Hinks, 2010b) suggests that the number of bodies concerned with auditing regulation may reduce with a possible merger of the FRC and the FSA. While interviewee comments could represent either their personal views or those of the regulatory body concerned, some common themes emerged.

The most important single impression to emerge from these interviews is that all the major themes which underpinned or emerged from the research, feature on regulatory agendas, either for short-term action or as more reflective ‘thought-projects’. Regulators are sensitive to current concerns of both users and auditors and are aware of their potential importance and the amount of noise currently generated by many of them. Regulators believe that the audit and assurance framework will inevitably experience significant change. One interviewee expressed this growing momentum in relation to the ‘front-end’ in particular:

...most people know what the question is; most people know what areas have to be looked at and I think that like it or not we are now going to have to get to the nitty gritty of what actually happens...
We have actually got to say what should happen in the front of the report and what auditors should do. (R4)

The following sections cover management commentary, audit reports, governance and liability, and judgement, process and regulation. Once again, the discussions highlighted the mutual dependency of the research questions.

Management commentary

The interviews reinforced the identified importance of management commentary, and the ‘front-end’, to investors.

From the work that we have done talking to investors I think it is pretty clear that they value what management says in the commentary, and outside of the financial statements, possibly even more highly than they value the financial statements... that begs the question whether or not auditors ought to be doing something with it. (R1)

Regulators are, then, actively considering the related assurance issue and while presently this may not suggest radically innovative solutions;

At the moment, from an ISA perspective, we’re probably quite similar to where it’s been in the UK – that the auditor’s obligation was to read it [management commentary], to be looking for inconsistencies with the financial statements and if the auditor was aware of a material misstatement of fact than the auditor had responsibilities. (R2)

...there is awareness by regulators that even the seemingly innocuous and familiar consistency approach may hold hidden complexities.
Is it just consistency with something in the financial statements or is it consistency with the auditor’s understanding and knowledge? ...but the complexity in going down that path is dependent upon how an auditor approaches an audit – your knowledge and understanding could be different. (R2)

Another regulator argued that consistency that involved comparison only with the financial statements was of extremely limited value:

Of course with most of the things that you have to look at for consistency, there is no reason why there would be any relationship between the information. For example, if management want to talk about internal control there is nothing in the accounts about internal control explicitly so by definition there never will be an inconsistency and never anything useful to report. So we have got a bit of issue on this; the Europeans have latched on to this idea which I think is originally probably British... It is one way, I think, of bureaucrats and civil servants giving an impression of something being done, whereas in reality it has very little meaning. [An alternative approach] would be that the auditor ought to give an opinion about whether or not what is written by the directors is consistent with the auditor’s knowledge. (R1)

Interestingly while all four interviewees commented on the hidden nuances of consistency, a desire for more than a consistency review was acknowledged:

...I think that, post financial crisis... I am not sure that [a consistency review] is going to meet user needs... I think we will have to think very hard about whether we have something that is more qualitative along the lines of whether the management commentary is a balanced presentation of the position. (R4)
There is also awareness of problems in assuring aspects of management commentary such as future-orientated information with one view being that process-orientated assurance might be appropriate, and reform of the liability framework, necessary, to realise this.

*I definitely think that you can’t step out beyond the boundaries of the current reporting model and structure without touching on the liability issue.* (R2)

The links between assurance on management commentary, audit reporting and the broader issue of who should provide corporate information to users, were highlighted:

*One issue is identifying who should be doing the reporting… this is really on the financial statements initially and not the narrative… is it the auditor, is it the audit committee or is it management? How should that balance be struck? At the moment the auditor gives an opinion on the financial statements issued by management but doesn’t give any assurance on the audit committee’s report. So it is not just about trying to change the audit report but looking at who should be providing the information.* (R1)

This individual rebutted the view that auditors commenting on management’s commentary constituted colonisation of management’s territory:

*I can really only give a personal view here, we have been looking at examples of how auditors might say more and invariably when you say more often it is a matter of re-interpreting the figures. The figures might be explained in one way by management but auditors might need to explain them in a different way so I think the book is still open as to whether or not auditors are justified on...*
commenting on these things or whether they passively comment on what management say because there isn’t really a true and fair view anymore. There are probably a number of true and fair views that you could have on the financial statements. (R1)

Generally, then, there is a sense that management commentary is important and that some assurance on it would be appropriate.

**Audit reports**

Leaving aside management commentary, regulators are aware that current pressure from users and other developments leaves scope for various ways by which to develop a revised audit reporting model. One regulator argued that the balance of investor opinion was in favour of audit reports which gave ‘more commentary on how the audit went’ rather than those in which ‘emphases of matter’ were routine rather than exceptional. Another, however, believed, contrary to some opinion, that users have little interest in the detail of the audit.

_I can’t get very excited about the audit process …we spend a lot of time pouring over auditing standards and frankly they’re pretty dull._ (R3)

This regulator expressed his personal view as to how audit reports might develop.

_I have a great deal of sympathy with the French view that says emphasis of matter is valuable. I think the ideal would be something like where management said at the beginning of the accounts ‘this has been a really difficult set of accounts to put together, there have been some difficult issues that we’ve had to grapple with and all the difficult issues have been summarised on_
page 93; then the auditors say it’s a true and fair opinion and urge the reader to look at page 93 because they agree those are the key assumptions. (R3)

This interviewee emphasised the importance of the auditor assessing whether the accounts as a whole told ‘the right story’; it was consistent with this that he stressed the continuing relevance of the true and fair opinion.

_I think what we need from the auditors is to provide an overview of the annual report to say ‘overall does this tell a story which I recognise?’ and, increasingly, I think that’s what the ‘fair’ bit of the true and fair view is about... ‘Is what I’ve seen in this annual report consistent with what I know about the business rather than is it true?’ ...the annual report needs to describe the whole business and it needs to be coherent..._ (R3)

This individual noted auditors’ reluctance to challenge companies robustly in areas, e.g. preliminary announcements, where they had no statutory authority, suggesting:

..._I suspect there will be a similar reluctance to challenge where there are inconsistencies across the annual report. They are effectively providing negative assurance; they’re not going as far as to say ‘we’re confident that all this adds together’. (R3)_

The last two comments reflect others made to the effect that there is a need for more holistic or ‘joined-up’ thinking to be a characteristic not just of audit or assurance but of corporate reporting. Two of the four interviewees suggested that the long-term relevance of the true and fair view could be problematic. As the ‘numbers’ for most listed companies
were now inherently reliable, the audit opinion might centre on the key judgements underpinning the corporate report.

...suppose you were to have a completely different report – forget all about true and fair – and just say ‘right, the areas on which the auditors are expected to report are the appropriateness of the accounting policies, the adequacy and effectiveness of the control systems...’ you opine on the soft areas of estimates and contingencies...’. (R4)

It was acknowledged, however, that any such move away from the true and fair view was likely to be very long-term. Summarising, there is recognition that audit reporting should, and will, be subject to future change although there is no certainty as to its future direction. Regulators have a clear sense that the various subjects of the present research are not mutually exclusive and that there is need for integrated thinking on both assurance and corporate reporting.

**Governance and liability**

It was emphasised that issues such as entity-specific audit reporting and ‘who’ reported assurance, and to ‘whom’, had governance implications. Specific considerations include whether or not ‘internal’ audit reporting to those charged with governance should be made public. The importance of non-executives’ disciplinary role was stressed by one regulator without committing to a particular reporting model. There was a general acknowledgement of uncertainty as to the reporting dynamics in terms of the precise responsibilities of auditors, audit committees and preparers. While changes to the present generic style of audit reporting and to the governance framework were not necessarily seen as off-limits it was suggested that the rationale for any such changes should be considered cautiously.
I think you do have to think about what’s the governance model, whose responsible for what, where will you get the most productive discussions so that you get the best quality information and if you put certain constraints into that system will it actually drive it the other way. (R2)

A change to more company-specific reporting, rather than that where detailed reports are the preserve of audit committees, might, it was argued, prejudice good auditor-director relations.

I think you’d have more hostile relationships with management. You’d probably have more hostile relationships with those charged with governance. So, ultimately is that going to support the quality of what we’re trying to get out there? ...we all need to go in with our eyes wide open as to both the intended implications and the unintended implications of shifting that model. (R2)

Most interviewees highlighted not just a binary choice between company and auditor reporting in management-commentary type terms but a ‘third way’ involving audit committees, not just as the recipients, but the source of such reporting. One individual suggested that the future ‘will see a more developed, informative report in relation to the activity of the audit committee’ (R4) and that he would expect the auditors to say so if they believed that such a report misrepresented auditor-audit committee communications. There were other similar comments:

One of the interesting suggestions that came in was the idea of the audit committee providing that more narrative report but the auditor then saying ‘yes that’s reflective of our discussions with them’. So, they were exploring almost a third in-between model. (R2)
One of the things we have found with investors is that many of them initially say they want the auditors to report to them but other investors on reflection say 'we have this framework of corporate governance and the audit committee is meant to be monitoring what the auditors do and so we think that perhaps it should be the audit committee that should be reporting but maybe the auditors ought to be giving some sort of opinion about whether or not what the audit committee has said in their reports does present fairly what the auditors have said to them'. (R1)

This last quote highlights further possible complexities. If audit committees are to act as primary reporters then a question arises as to whether or not what they are reporting should be the product of what the external auditors have originally reported to them. The possibilities are several; little or nothing appears ruled out from a regulatory perspective. Exploring the issues with auditors identified a strong view that widening the scope of assurance would require concessions on auditor liability. One regulatory representative had sympathy with that view and believed that if auditors were to get involved with areas such as the quality of management or future prospects or were to write management-type commentaries themselves this would have implications, not just for governance dynamics, but for auditor liability.

Once you have comments on future prospects or the quality of management or all of those sorts of things I think you definitely have to have... some sort of safe harbour or something that helps deal with that. (R2)

There is an alternative perspective which, while conscious of problems inherent in opining on soft or forward-looking information, and of the possible need for ‘safe harbours’, is less sympathetic. It was suggested, contrary to the prevailing view as to why the Companies Act
2006 provisions for limiting liability have so far proved unproductive, that audit firms:

...have plainly made a calculated decision that by not taking advantage of the permission to have contractual arrangements with companies they will be able to argue for a statutory imposed regime in the future. (R4)

Judgement, process and regulation

Perspectives differed on these topics depending both upon which body the interviewee represented as well as personal opinion. One robustly expressed view was that there was scope for auditors to exercise a greater degree of professional scepticism.

We expect a lot more from auditors than they’re currently doing. We expect auditors to spend more time challenging management’s assumptions and using their own models. So professional scepticism, we think, is hugely important; it applies to any asset that depends on future cash flows and their valuation and I guess would apply to any liability. (R3)

Recognising the primacy of judgement or scepticism invites a response to the contention of many auditors that ever increasing regulation has reduced the scope for them to exercise professional judgement. There is some limited sympathy for this view:

...particularly from an auditing standard perspective, the inspectors are one of our big constituents and they want objective standards that make their job easier... Yes, we’re still principles-based but there is a desire to have some sort of level of consistency. I wouldn’t underestimate the amount of judgement that’s still involved [but]
I think there is a bit of regulation overload which feels like its impinging on some level of judgement. (R2)

At the same time the point was made that:

The AIU have some fairly genuine horror stories of things they see on audits – not generally but on some audits and I think they would argue that there is quite a good argument for having documentation requirements because at least it makes people stop and think about what it is they are saying in the audit report. (R1)

A challenging perspective on this issue was provided by a regulator, who while acknowledging that a reduction in the scope for exercising judgement was the result of many factors, many of them outwith the profession’s control, argued that one of the main drivers has been the firms’ own imperative to reduce audit risk by a consistency of approach throughout their global operations and the exercise of significant judgement only by those of appropriate seniority.

Well, I obviously can’t argue with the fact that regulation has led to a focus by the firms on how they demonstrate that they have done a good job... However, I think that they are very good at forgetting one of the fundamental reasons why audit firms have methodologies. The firms all develop their methodologies to ensure consistency of approach across the entirety of their operations globally and to be able to record it so they can demonstrate for litigation and risk management purposes what they have done. It is very convenient to pass that buck to others who come along long after those methodologies were developed. (R4)

The relative emphases placed on process and judgement is dependent on auditor skills and staffing models. While there was recognition
that extending the scope of assurance might pose challenges in terms of auditor skill-sets for particular sectors or companies the view was expressed that the profession should be able to source any such expertise. One individual did pinpoint auditor skills as key to any proposal to extend the scope of assurance beyond the financial statements.

One issue is the extent to which auditors have the skill sets or whether different people will have to give assurance on this sort of thing. Perhaps you could still call them the auditors, and they would be trained and obviously perhaps you don’t need to have training so much in the financial way. You wouldn’t want to have students who are still training to do this sort of thing. (R1)

Another interviewee cast doubt over the necessity of auditors carrying out so much of what he termed ‘grunt work’ given the inherent reliability of the basic accounting systems in most listed companies. This view, when considered with a posited increased emphasis on judgement and the view that auditors are insufficiently sceptical, prompts reflection as to the appropriateness of the customary staffing structures and business models employed by the profession particularly in the light of possible future developments in practice.

Other issues

Other issues mentioned included auditor-investor dialogue; it is recognised that because of the amount of noise coming from investor communities on this, ‘something will change’ although it is unclear as to what precisely. Regulators are also aware of the related issues of timeliness and audit reporting on information releases put out, other than the annual report, by companies.
Another area we want to look at is whether auditors ought to be reporting on a more timely basis on other releases – things put out on their quarterly announcements, on their prelims or indeed on any sort of statements that companies make. It is interesting when you look at the report on [XXXX]... they asked the auditors ‘what did you do for the quarterly numbers?’... the answer was ‘we did what the standards say’ which is enquiry, observation and an analytical review which of course doesn’t really involve verifying anything. I think there is also a question of the timeliness of information. (R1)

Summary

This chapter has investigated the opinions of regulators on the principal research issues research. The main points are:

• Regulators are acutely aware of the challenges posed by developments such as increasing user reliance on the ‘front-end’ of the annual corporate report, the possible provision of assurance on forward-looking or ‘soft’ information and the desire of users for more informative audit reports. There is recognition that audit’s relevance is being questioned (not least, perhaps, by the firms themselves) and that the debate requires to progress to considering specifics.

• The assurance implications of an increasing reliance by users on the ‘front-end’ are under consideration by regulators. The same applies to users’ wish for audit report reformation. Regulators are aware that some changes to the existing assurance model would have governance implications.

• There is awareness of other issues; for example, the arguably detrimental effect of regulation on the exercise of auditor judgement by auditors, the possibly inhibiting effects on changes to the assurance
model of the existing liability framework and the question of the adequacy of auditor skills.

• Views differ on several of these issues between the individuals interviewed and the bodies represented by them. As well as a general recognition of a need to move forward on many of the issues there is a strong sense of their mutual dependency. Corporate and audit reporting, and the respective responsibilities of preparers, auditors and audit committees, require simultaneous consideration.
10 Conclusions

We must take the current when it serves or lose our ventures.
(Julius Caesar, 4, 3, 218-224)

Introduction

This chapter summarises the research conclusions, under five headings which correspond to the research questions. These are: management commentary; assurance on management commentary; process, rules and judgement; audit reporting; and auditor-investor dialogue. The chapter then explores the implications of the research for policy makers and regulators and for the future of external audit and assurance. The chapter concludes by suggesting where further research is required or would be appropriate.

Management commentary

The first research question explored auditors’ perceptions about management commentary itself. Auditors generally believe that management commentary, and the ‘front-end’ more generally, is important and that this importance will increase. The perceived inaccessibility of financial statements, as narrowly defined, is important here; the opaqueness of IFRS-based financial statements was specifically highlighted. However, there are reservations about the usefulness of existing management commentary due to both management spin and boiler plate disclosures. Thus there is some opinion which envisages a need not just for more useful management commentary but for radically revised corporate reporting generally emphasising not only the financials
but more business-orientated reporting. Initiatives such as that of ICAS (2010a) are consistent with this but some individual visions of the future go beyond this, for example by providing more elaborate discussions of future prospects.

**Assurance on management commentary**

The second and third research questions explored perceptions regarding management commentary assurance. Generally, assurance on management commentary, and the ‘front-end’, is regarded as important and auditors are significantly more positive on this than are investors who themselves hold positive views on this. Auditors scored the need for assurance on some elements of management commentary greater than investors, although the opposite also applies. There is no significant difference between auditor and investor opinion in terms of the need for assurance on the key aspect of ‘future prospects’.

Auditors believe, unsurprisingly, that content assurance is more feasible for less problematic elements of management commentary whereas for more problematic, qualitative or future-orientated elements, there is a preference for process or consistency forms. A substantial proportion of auditors, however, believe that one or more of the proposed forms of assurance (consistency, process, content) are possible for even the most problematic elements of management commentary. The form of management commentary assurance is one of the few points where there is clear divergence of view between Big Four and non-Big Four auditors with the former showing a relative preference for process; this could reflect greater familiarity with systems-based assurance.

There is relatively little opposition to management commentary assurance in principle and objections are largely non-technical. For example, parallels were drawn between assurance on future-orientated financial information and the technical nature of work carried out, for example, in due diligence contexts. It was pointed out in several cases
that auditors may already carry out informal assurance on management commentary. Positive comments were made about auditors’ ability to opine on qualitative areas not necessarily closely related to the financial statements. Risk is one such example and auditors’ positive attitude on this contrasts, perhaps predictably, with that of the UK House of Commons Treasury Committee (HCTC). The HCTC has suggested (HCTC, 2009) that auditors have only limited capability to provide assurance on the risk management of banks. While a need to recruit, for example, non-financial, specialists is perceived as possibly necessary, in certain circumstances, smaller firms might be being potentially disadvantaged in this regard.

In the same way as assurance is not envisaged as infeasible technically, the financial implications are not seen as being insuperable, although opinions on the incremental costs vary widely. While some auditors suggested that it was impossible to estimate the average percentage increase to the audit fee which might result from providing substantive assurance meaningfully, the mean increase suggested was around 25%. Similarly regulators who participated in the research do not envisage insuperable technical or financial barriers. It was pointed out that professional firms should be able to source any additional skills required, that some revision of customary firm staffing structures may become necessary and that higher assurance costs should result in lower costs of capital. Perceived non-technical obstacles to assurance, however, are much more significant. Three matters particularly stand out.

First, some auditors believe that management commentary assurance, particularly, in more judgemental areas, would blur management and auditor responsibilities. This concern is one not solely related to management commentary but to any assurance engaging with management judgements. As such, it potentially affects the enhancement of audit reports by incorporating more judgemental or entity-specific material. Second, there is a related concern in respect of possible models for reporting management commentary assurance. There are
perceived difficulties in providing assurance in ‘true and fair’ terms and a consequent lack of enthusiasm for reporting this via the standard audit report. This reflects the significant ‘soft’ content in management commentary. Interestingly, while auditors are relatively enthusiastic about standard audit reports but unenthusiastic about extending their use to cover management commentary, for users the reverse applies. This may indicate that, long-term, the future of the true and fair opinion is problematic. None of the reporting alternatives put to auditors attracted clear majority support; developing an acceptable reporting model is therefore challenging. Given calls for cohesive and ‘joined-up’ corporate reporting, however, it seems opportune to develop a reporting model covering assurance on both the ‘front’ and ‘back’ of the annual report. Third, auditor liability is an obstacle to widening the scope of assurance in the minds of many auditors; the point was made that it is only the liability issue which would require two assurance reports rather than one covering the entire annual report.

Summarising, the research suggests strongly a need to push ahead with some form of assurance on the ‘front-end’. There are issues to be addressed in respect of liability, the form of reporting to be adopted and the demarcation of auditor and management responsibilities. There are also concerns about the development of a more radical, useful and cohesive corporate reporting and assurance package. It seems inappropriate, therefore, to consider the management commentary issues in isolation.

**Process, rules and judgement**

The fourth research question explored auditors’ perceptions as to the robustness of the external audit process. While auditors appear generally neutral as to whether regulation has affected the balance between judgement and process beneficially or otherwise, they generally view the impact of regulation on auditors’ exercise of judgement
negatively. There is some perception that audit quality is equated with regulation compliance although this is juxtaposed with appreciation of the difficulties faced by regulators. Auditor perceptions of decreasing scope for exercising judgement echo the perceptions of users at the first research stage.

Some auditors acknowledge reasons other than regulation for an increasing reliance on process; this reinforces a point made by a regulator to the effect that the main driver of process was the large firm drive to ensure uniformity of approach throughout worldwide operations. Whatever the reasons for an increased process emphasis there is a perception that possible future developments, particularly assurance on the ‘front-end’, may require an intensified emphasis on judgement. These impressions are consistent with the recent joint call by the FSA and the FRC (FSA & FRC, 2010) in the UK for auditors to exercise more scepticism and to challenge management more rigorously. Widening the scope of assurance to include the ‘front-end’ and more robust engagement with management may make some revision of customary professional firm staffing and business models appropriate.

Audit reporting

Audit reporting was the subject of the fifth research question and the most apparent divergence between the respective views of auditors and users. Auditors are significantly more favourably disposed towards existing audit reports than are users. This distinction in turn reflects differing views of the usefulness of the true and fair opinion. Auditors are more wedded than users to generic style reports where key judgements or details of the audit remain invisible. This mindset is consistent with ‘improvements’ to audit reports which would be consistent with past innovations to reporting of an ostensibly ‘educational’ nature.

A significant element of auditor opinion, however, echoes users’ views that audit reports require to incorporate much more entity-specific
material; for example, in terms of specific audit issues of a judgemental nature or key accounting judgements. Many auditors appear to believe, in principle, that they should say more and that investors and other stakeholders should receive audit reports which are more obviously useful. There are various forms which more expansive audit reporting might take; while they are not mutually exclusive the main competing possibilities appear to major on more entity-specific detail on either the audit itself or the key accounting judgements.

The perceived obstacles are similar to those identified in respect of management commentary assurance. Liability issues are seen similarly this is unsurprising as assurance on the ‘front-end’, with its significant ‘soft’ and subjective content, has much in common with audit reporting which highlights judgemental matters. Reporting on the more subjective content of management commentary is perceived to have liability implications distinct from those resulting from more expansive audit reports, hence auditors’ evident lack of enthusiasm for reporting on management commentary in terms of truth and fairness.

As in the case of auditor liability, the potential for conflating management and auditor responsibilities is seen as an obstacle to more informative audit reporting. This may affect the relationships between auditors and management and the dynamics of governance. There is some perception that management would regard more detailed audit reports unfavourably although this remains to be empirically tested. One way of actualising more informative audit reports could be to put something like auditors’ existing reports to audit committees into the public domain but this may inhibit the nature of auditor-auditor committee relationships.

Summarising, more detailed audit reports are technically possible. As for management commentary, however, it may be necessary to achieve some resolution of the liability issue as a condition of progress. The implications for governance, e.g. director-management relationships, require exploration with preparers and with non-executives. More
radical auditor views echo those favouring more cohesive and business-orientated corporate reporting with, for example, the suggestion that auditors might write their own management commentaries on those of management. In the long run, the true and fair opinion itself may not be sacrosanct.

**Auditor-investor dialogue**

The sixth and final research question was concerned with how more substantive interaction between auditors and investors should be facilitated. Audit committees are regarded by some as the obvious and, in some cases, the only permitted conduit for auditor-shareholder communications given existing corporate governance structures.

Outwith these constraints there are other possibilities in terms of audit reports or ‘front-end’ assurance. Extended audit reports may be one of the apparently more straightforward means of enhancing auditor-investor dialogue while, more radically, auditors’ commentaries on those of management might constitute effective dialogue. In terms of more specific dialogue possibilities, ‘cold’ questions to auditors at AGMs are viewed unenthusiastically and private meetings between auditors and investors are generally regarded as unacceptable. Written questions to auditors in advance of AGMs or the use of websites, however, appear to be feasible possibilities.

**Summary, policy recommendations and further research**

The report on the first research stage (Fraser *et al.*, 2010) identified a strong appetite on the part of users for enhancing external assurance in terms of, first, extending its scope to the ‘front-end’ of the corporate annual report and, second, more informative reports and, less crucially, other conduits for auditor-investor communication. Recent financial
and economic events give these concerns added force. The research reported here has identified that auditors are prepared to respond positively to significant elements of investors’ concerns.

In principle, at least, auditors appear prepared to provide assurance on management and similar disclosures. There are few purely technical obstacles to extending the boundaries of assurance. Similarly, more useful audit reports and better communication between auditors and investors are regarded as technically possible, although auditors are generally supportive of the existing true and fair view opinion. This propensity in favour of generic reporting reflects widespread concerns about the liability implications perceived to follow from extending either the scope or nature of assurance and audit reporting. The strategic issues facing the audit profession, therefore, require an acceptable solution to the liability issue. Imaginative thinkers representing both users and auditors envisage a response to the issues in terms of moving towards a cohesive and ‘seamless’ reporting paradigm embracing not just the financials but key narrative disclosures and with an integrated assurance function on both.

Despite the support of auditors for the true and fair view, the long-established UK pattern of audit reporting in generic terms such as ‘true and fair’ may have a limited long-term future. Reasons for this include: the perceived difficulty of opining on management commentary in ‘true and fair’ terms; opinion favouring entity-specific audit reports; and the thinking of some regulators. Other issues for resolution, depending upon the solutions proposed, include consideration of the corporate governance implications and the reactions of preparers and non-executives. User concerns about possible over-emphasis on process at the expense of judgement are echoed to an extent by auditors although there are varying views as to whether an increased emphasis on process is imposed on or by auditors.

It is clear that over the user and auditor constituencies as a whole there is an appetite for significant changes to the assurance function, or,
at the least, some acceptance of their inevitability. These undercurrents are echoed in many of the more visible initiatives and pronouncements by a variety of regulatory, professional and semi-official bodies which have been discussed in chapter two of this report. While the precise parameters of possible change may be unclear, and while issues remain to be researched, it is clear that the time is now opportune for concrete policy proposals which can be explored with key stakeholders.

These proposals should not be restricted to assurance but should at least take account of proposals for more cohesive and easily accessible corporate reporting encapsulating data of both a financial and non-financial, and a quantitative and qualitative nature. Recent ICAS initiatives (ICAS, 2010a, b) provide a possible starting point. Proposals for new forms of corporate reporting may be juxtaposed with a new audit-reporting model that engages with all the above elements of corporate reporting and which goes some way in the direction of an entity-specific and judgement-focused character.

The research has highlighted an urgent need for further work on several matters. First, and most pressingly, the issues require to be explored with those who represent audited entities themselves; both preparers and non-executives, particularly audit committee members. The issues for exploration do not merely replicate those explored with users and auditors. The agenda has progressed. Two new issues in particular have emerged with particular relevance to audited companies; the strong sense that a more cohesive and accessible form of corporate reporting is required and the realisation that moves towards a more entity-specific audit reporting model, and/or enhanced auditor-investor dialogue, may have particular implications for corporate governance arrangements and for auditor-investor relations. Second, serious consultation is required in order to achieve an acceptable resolution of the perennial auditor liability issue which will permit proposals on reforming assurance to progress to implementation. Third, there is scope for research on the balance of process versus judgement in the audit process. What,
or who, are the inhibitors of a greater emphasis on judgement in the audit process? There are quite different views on this issue.

Recent financial and economic events, the conclusions of this research and other key initiatives all suggest that radical reformation of external assurance is required. The nettle must be grasped.
REFERENCES

Accountancy Age (2009), ‘The top 50 +50 2009’, Accountancy Age, 18 June, pp.16-22.


Christodoulou, M (2009), ‘Audit reports targeted for reform’, Accountancy Age, 29 October.

Christodoulou, M (2010), ‘Top firms launch search for bigger role in company audits’, Accountancy Age, 15 April, p.2.


Financial Services Authority (FSA) and Financial Reporting Council (FRC) (2010), The UK Corporate Governance Code, Financial Services Authority and Financial Reporting Council, London

Fraser, IAM and Henry, WM (2009), ‘Ticking the commentary box’, CA Magazine, October, p.58.

Fraser, IAM and Henry, WM (2010), Meeting the needs?: User views on external assurance and management commentary: Research Summary, The Institute of Chartered Accountants of Scotland, Edinburgh.


Institute of Chartered Accountants of Scotland (ICAS) (2010a), Making corporate reports readable – time to cut to the chase, The Institute of Chartered Accountants of Scotland, Edinburgh.


MARC (2010), *The value of audit: research project commissioned by the Standards Working Group/Global Public Policy Committee*, Maastricht: Maastricht Accounting, auditing & information management Research Center.
Public Company Accounting Oversight Board (PCAOB) (2011), Concept release on possible revisions to PCAOB standards related to reports on audited financial statements, Public Company Accounting Oversight Board, Washington, DC.


ABOUT THE AUTHORS

Ian Fraser is Professor of Accounting and Chair of the Division of Accounting and Finance of the Stirling Management School, University of Stirling. He has also held academic posts at the University of Strathclyde and Glasgow Caledonian University. He is a member of ICAS and he trained in Glasgow with Thomson McLintock and Co, one of the predecessor firms of KPMG. He has research interests in auditing, corporate governance and financial accounting and has published extensively in these areas.

Jacqueline Pierpoint has assisted in the preparation of numerous papers and research reports published by both ICAS and the ICAEW. Her training as an inspector of taxes included both accountancy and law and she has worked in industry. She has been involved in accounting research since 2001.
The research projects which culminated in this publication were funded by grants from The Scottish Accountancy Trust for Education & Research (SATER) – a registered Scottish Charity (SC034836). The SATER Trustees are pleased to have been able to support these projects and hope that the results are of interest and relevance to a broad range of users.

SATER’s objective is to promote research into, and education of, accountancy, finance and management together with all subjects in any way related. In fulfilling its charitable objectives, it also seeks to provide public benefit by making grants for research projects which result in reliable evidence for use in the development of policy – by professional bodies, standard setters, regulators or governments.

SATER is happy to receive grant applications for research projects from within and outwith the University sector, so long as these utilise sufficiently robust research methodology and the results from the project are likely to provide public benefit.

SATER considers a broad range of grant applications from anywhere in the world. These do not have to be solely for research projects but can be for other research or education initiatives within SATER’s specific subject areas, and must be expected to provide public benefit.

The Trustees would like to thank the ICAS Research Committee and Research Centre staff for their support, through liaison with the academic team and the provision of advice and assistance at various stages of the project. Their role in reviewing publication drafts and providing constructive comments to the authors has been invaluable in producing publications which are easily accessible and of interest to ICAS members, the interested public and policy makers.

Further details about SATER and the ICAS research programme can be found from the SATER and ICAS websites: scottishaccountancytrust.org.uk/research.html and icas.org.uk/research.

David Spence
Chairman of SATER
September 2011
In the aftermath of the financial crisis, change seems inevitable for the audit profession. Following numerous inquiries there are currently proposals at both the European and UK levels. It is imperative that the audit profession itself responds to these challenges and engages in the debate. This timely research report investigates the views of auditors regarding change. This study is based on a questionnaire survey of auditors and interviews with auditors and regulators and investigates views on assurance on management commentary and more general views on the scope and value of the current audit.

This study finds that auditors are prepared to respond positively to investor and user concerns. However, auditor liability continues to be considered a significant obstacle. It is argued that radical reformation of assurance is required and that this should be considered, together with the need for more cohesive and accessible corporate reporting to ensure that the new audit-reporting model is more entity-specific and judgement-focused.