Meeting the Needs?
User Views on External Assurance and Management Commentary

The recent financial crisis has again brought to the fore questions surrounding both the scope and quality of the external audit. In conjunction with this, narrative reporting or management commentary continues to grow in importance in the annual reports of companies and therefore the question as to whether and, if so, how assurance should be provided on such information is fundamental.

This project investigates views on the value and importance of management commentary and whether there is a demand by corporate report users for external assurance on management commentary. Users’ opinions about these issues also naturally turns attention to more general views on the scope and value of the current statutory audit, looking particularly at the level of confidence in the present external audit process, the perceived usefulness of current external audit reports and views as to how the usefulness of audit reports might be enhanced. These more general findings are therefore also reported in this study.

This study is based on a questionnaire survey of professional and private investors, finance professionals and other users. This was supplemented by interviews to explore the issues in greater depth.

A second stage of this project is currently in progress – this will investigate whether auditors are able and willing to provide assurance on management commentary.

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User Views on External Assurance and Management Commentary

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# CONTENTS

*Foreword* ................................................................. i  
*Acknowledgements* .................................................. iii  
*Executive Summary* .................................................. v  

1. **INTRODUCTION** ....................................................... 1  
   - Development of narrative corporate reporting .................. 2  
   - Contemporary developments and position ....................... 3  
   - Structure of report ..................................................... 10  

2. **LITERATURE REVIEW** ................................................. 11  
   - Introduction ............................................................... 11  
   - Corporate reporting .................................................... 11  
   - Assurance on management commentary .......................... 19  
   - Summary ................................................................. 36  

3. **The RESEARCH METHOD** .............................................. 39  
   - Research objectives and questions ................................. 39  
   - Questionnaires .......................................................... 40  
   - Interviews ................................................................... 45  
   - Analysis and discussion of results ................................. 47  

4. **MANAGEMENT COMMENTARY: STAKEHOLDER PERCEPTIONS** ................................. 51  
   - Introduction .................................................................. 51  
   - Knowledge of corporate reporting and of management commentary .. 51  
   - Perceived importance of narrative reporting and of management commentary ........................................... 54  
   - Perceived importance of management commentary in understanding corporate attributes .................................. 62  
   - Barriers to management commentary usefulness ................ 71  
   - The structure of management commentary ....................... 76  
   - Summary ...................................................................... 80
## Contents

5. **Enhancing Management Commentary Usefulness: Assurance**  
   
   **Introduction** ................................................................. 81  
   Assurance on management commentary ................................ 81  
   The scope and extent of assurance on management commentary  99  
   Cost implications of providing assurance on management commentary .................................................. 111  
   Implications for audit firms .................................................. 114  
   Communication of assurance on the management commentary .................................................. 116  
   Summary ............................................................................. 120

6. **Enhancing the Value of External Audit: Process, Reporting and Dialogue**  
   
   **Introduction** ....................................................................... 125  
   Value of the audit process ..................................................... 126  
   Usefulness of external audit reports ....................................... 138  
   Enhancing investor-auditor dialogue: other possibilities ........ 151  
   Summary ............................................................................. 155

7. **Conclusions and Recommendations**  
   
   **Introduction** ........................................................................ 157  
   Stakeholder perceptions on management commentary ............ 157  
   Provision of external assurance on management commentary .... 159  
   Extent and depth of assurance on management commentary ...... 161  
   General issues of audit and audit reporting ........................... 163  
   Wider issues and implications .............................................. 165  
   Overall summary and policy recommendations ....................... 167

**References** .......................................................................... 169

**About the Authors** ............................................................... 177
FOREWORD

The recent financial crisis has again brought to the fore questions surrounding both the scope and quality of the external audit. In conjunction with this, narrative reporting or management commentary continues to grow in importance in the annual reports of companies and therefore the question as to whether and, if so, how assurance should be provided on such information is fundamental.

This project investigates views on the value and importance of management commentary and whether there is a demand by corporate report users for external assurance on management commentary. Users’ opinions about these issues also naturally turns attention to more general views on the scope and value of the current statutory audit, looking particularly at the level of confidence in the present external audit process, the perceived usefulness of current external audit reports and views as to how the usefulness of audit reports might be enhanced. These more general findings are therefore also reported in this study.

This study is based on a questionnaire survey of professional and private investors, finance professionals and other users. This was supplemented by interviews to explore the issues in greater depth.

The key findings pose general challenges as both investors and non-investors are at best only mildly confident in the current external audit process and believe that current audit reports have very limited usefulness. On the more specific issue of management commentary, this was generally perceived as useful although it was recognised that its usefulness could be limited by boilerplate language and the fear of being held accountable for unrealised predictions on the one hand and ‘management spin’ on the other. Generally, both investors and non-investors believe that it is desirable that at least some level of external
assurance is provided on management commentary. The study recognises that the different elements of management commentary pose distinct challenges to the type of assurance which can be provided on for example future prospects compared to say past results.

A second stage of this project is currently in progress – this will investigate whether auditors are able and willing to provide assurance on management commentary.

This project was funded by the Scottish Accountancy Trust for Education and Research (SATER). 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 add to the debate about the future of audit assurance.

David Spence
Convener, ICAS Research Committee

April 2010
This research project benefited from the support and co-operation of a large number of individuals, as well as a number of organisations. We would like to thank everyone who replied to either of the two questionnaire surveys and we are grateful to those who agreed to be interviewed. In this regard, we are very thankful that fund managers, analysts, private shareholders and others, were so willing to help us at a time of global economic and financial meltdown; the interviews for the research were largely carried out during the autumn and early winter of 2008 in the wake of widespread corporate failure in the financial sectors of the UK and other nations. To preserve confidentiality, our interviewees are not named here but the researchers and the ICAS Research Committee appreciate their contribution greatly.

We wish to thank both the Securities and Investment Institute and the UK Shareholders Association for facilitating the execution of the questionnaire surveys. The assistance of both bodies is appreciated greatly. Thanks are also due to three colleagues within the Accounting and Finance Division, Stirling Management School, University of Stirling – Donna Johnston for her help with the interview transcription, Isaac Tabner for providing very valuable interview contacts and Tamer Elshandidy for ad-hoc research assistance. Joanna Stevenson, former Lecturer in Accounting at the University of Stirling, is due a special word of thanks for her contribution to the genesis of the research.

Finally, the researchers and the Research Committee acknowledge the assistance of the Trustees of The Scottish Accountancy Trust for Research and Education in providing financial support.
The emphasis given to narrative disclosure in corporate reporting, both in the UK and internationally, has greatly increased in recent years. A major example of this within the UK was the erstwhile proposal for a statutory ‘operating and financial review’ (OFR). More recently, the International Accounting Standards Board (IASB) issued an important discussion paper on ‘Management Commentary’, the more generic international incarnation of the OFR. This discussion paper has now been followed by an exposure draft (IASB, 2009) which defines management commentary as follows:

A narrative report accompanying financial statements prepared in accordance with IFRSs that provides users with historical and prospective commentary on the entity’s financial position, financial performance and cash flows, and a basis for understanding management’s objectives and its strategies for achieving those objectives. (IASB, 2009, p.17)

These developments suggest that in the future the narrative components of annual corporate reports will assume still greater significance; this, in turn, raises the important question of whether or not there is a demand by corporate report users for external assurance on management commentary and on other similar reports. This constitutes the primary motivation for the present research.

User perceptions as to the desirability of assurance on management commentary may hinge partially upon broader issues – perceptions of the robustness of the extant external audit process and of the value of existing external audit reports generally. User views on the underlying strength
of the audit process, for example, are likely to influence perceptions of
the ability of auditors to provide assurance on management commentary,
which has a relatively high proportion of subjective and difficult to assess
content. Likewise, if existing audit reports hold only limited benefit for
users then this demands resolution before the scope of audit reporting can
be usefully extended. The research also takes the opportunity, therefore,
to explore these broader issues.

The research is particularly germane to the current economic and
financial situation. The unfolding drama which reached a climax in the
autumn of 2008 and which revealed ever-more evidence of corporate
weakness and systemic failure has fortuitously created an opportunity to
investigate users’ perceptions of external audit and, where appropriate,
corporate reporting generally at a critical time in economic history.
Criticisms, sometimes perhaps inappropriate, of fair value accounting
and of the opaqueness which is arguably inherent in some aspects of
IFRS-based corporate reporting may suggest that there is demand for
corporate reporting to be disseminated through more transparent and
accessible channels. Additionally, perhaps, sober reflection on the way
contemporary capitalism works has provided an opportunity for debate
about how a reformed external audit function could contribute to market
economy stability. While the research does not address these broader
issues directly, they constitute an additional dimension of relevance.

The three specific research objectives in this report are to identify and
explore the views of investors, and where appropriate other stakeholders,
on:

(1) the value and importance of the management commentary and the
factors that inhibit that usefulness;

(2) the need for external assurance to be provided on the management
commentary and the extent and scope of the audit assurance that
should be provided; and
(3) the extent of confidence in the present external audit process, the perceived usefulness of current external audit reports and views as to how the usefulness of audit reports might be enhanced.

The research was conducted in two stages. In the first stage, two questionnaire surveys were carried out; the first was administered to professional and private investors and to other finance professionals (206 responses; response rate 12.1%); the second, and shorter, was sent to users and stakeholders other than investors (82 responses; response rate 11.6%). The second research stage involved 26 semi-structured interviews which explored the issues surrounding management commentary in greater depth.

Findings

The findings demonstrate that users exhibit a wide diversity of views; these, however, can be summarised as follows:

• Users perceive the management commentary to be a useful corporate report; while at the same time, several factors, such as the use of ‘boilerplate’ language and the fear of being held accountable for unrealised predictions, are perceived to reduce its usefulness.

• Management commentary is perceived as being important in understanding corporate dimensions such as key resources, risks and relationships, past results, future prospects and performance measures and indicators but it is recognised that many of these attributes are vulnerable to management ‘spin’ and distortion. Specific constituencies of users, and even investors, differ in the importance they attribute to management commentary; some categories of expert user, for example sell-side analysts, have relatively little use for it. Differences between different investor categories might be usefully taken into account in future iterations of conceptual frameworks such as that of the IASB.
• While differing views on the relative importance of the negative effects of factors such as ‘boilerplate’ wording on the one hand and ‘management spin’ on the other, provide context for differing perspectives on the regulatory approach that should be adopted in respect of management commentary structure and content, most opinion favours a ‘light touch’ approach. The most favoured is one whereby the IASB, or other regulator, would mandate a minimal template for the structure and content for management commentary but would permit some element of discretion and ‘corporate house style’.

• Generally, both investors and non-investors believe that it is desirable that at least some external assurance be provided on management commentary to identify inconsistencies between narrative statements and the hard data currently audited, to curb excessively optimistic directors’ statements and to provide more transparent disclosure. The perspective of professional investors, in general, is less enthusiastic than the average, possibly reflecting both a desire not to inhibit corporate style and content and scepticism about the capabilities of the existing external audit. In addition, some categories of expert users, perhaps analysts most obviously, have access to other information sources and have, therefore, less need for assurance on management commentary.

• Assurance on management commentary may be especially important for small investors or non-investor stakeholders; neither constituency is likely to have access to the alternative information sources available to professional investors.

• Different elements of management commentary content pose distinct challenges. Users are more positive about assurance on the more obviously ‘verifiable’ components such as ‘past results’ and ‘key resources, risks and indicators’ but views regarding assurance on ‘softer’ components such as ‘future prospects’ are less positive; there are perceptions that auditors might report in ‘softer’ terms;
for example, whether or not these aspects were ‘reasonable’ or ‘not unrealistic’ in the light of knowledge at the time.

• Generally, there is a preference for applying more robust approaches to assurance, e.g. ‘audit of content’, to more historic and quantitative content elements of management commentary while applying softer approaches, e.g. ‘audit of consistency’, to ‘softer’ or qualitative elements.

• There is a general preference for communicating management commentary assurance in the standard audit report, as opposed to in a separate stand-alone version.

• Both investors and non-investors are, at best, only mildly confident about the robustness of the current external audit process; some are decidedly unconfident. Specific concerns include the perception that audits are often ‘process’, rather than ‘judgment’, driven.

• There is a high level of consensus across all users that current audit reports have very limited usefulness. There is an evident need and demand for audit reports to be radically enhanced to incorporate more entity-specific information and to better reflect the judgements made by auditors. Current initiatives, such as those of the UK Auditing Practices Board (APB), do not appear to be sufficiently radical in this regard. There is a need for auditors to ‘reconnect with investors’.

• Confidence in any assurance arrangements for management commentary seems likely to be enhanced should these more general concerns on the audit process and audit reporting be addressed effectively.
Summary, policy recommendations and suggestions for further research

The key findings may be summarised succinctly: users generally find management commentary useful and there is a demand for associated external assurance. There are various views as to the required scope and depth of this assurance. Audit reports generally are not regarded as useful and there is only limited confidence in the external audit process. Some of these findings have clear policy implications while others require further research and consideration.

Policies are needed to ensure that audit report usefulness is enhanced and to facilitate substantive dialogue between auditors and shareholders. The UK APB has taken steps towards making audit reports more informative (APB, 2007) but the research indicates more radical policies may be required. Audit reports should focus much more on risks, uncertainties and other entity-specific matters.

There is also a need for policies to reinstate the relationship between auditors and shareholders not just in legal form but in substance. Further research is needed to determine how best to pursue this issue. Other findings suggest that further research is required prior to the formulation of detailed policy measures. Research should explore whether auditors are able and willing to provide assurance on management commentary, and if so, at what level and scope. This is particularly important given that the prevailing attitude of the auditing profession to assurance on management commentary appears to be cautious. The views of auditors on these issues are currently being investigated in a second stage of this project. Further research on auditor views on the matter, therefore, may have implications for audit education or for the provision of assurance other than by the external audit profession. More generally, research is needed to develop future policy measures aimed at making the external audit a more useful product.
These more general concerns and those specifically focused on management commentary are not mutually exclusive. Providing assurance on management commentary, for example, may make the external audit more useful although without also enhancing audit reports this may be of limited value. Together, the issues highlight both threats and opportunities for external auditors. The recent financial meltdown has again resurrected the perennial question as to what may reasonably be expected from auditors. It may be opportune to reflect, if necessary, radically, on what investors and other stakeholders really want from external assurance in the twenty-first century. Unwillingness by regulators and firms to facilitate more useful assurance arrangements might exacerbate these tensions. More positively, bold policy measures that are responsive to the issues highlighted in this report may result in more valuable external assurance.
Considerable growth in the narrative content of company annual reports over the past forty years or so has been reflected in initiatives suggestive of a more narrative and business-orientated corporate reporting model. This research report has a focus on one important aspect of these developments – the increasing occurrence of the publication of a management commentary (or similar reports such as ‘operating reviews’) by larger corporate enterprises in their annual reports. The increasing attention given to management commentary, of which the UK variant became widely known during the nineteen nineties as the operating and financial review or OFR, resulted in the publication of the major discussion paper *Management Commentary* by the International Accounting Standards Board (henceforth IASB; IASB, 2005). Indications that narrative disclosures such as management commentary are likely to assume an increasing importance in the context of the corporate reporting package generally, raise the question of whether or not assurance can or should be provided on these narratives. This research report has a particular focus on this fundamental assurance issue. Consideration of assurance within the management commentary context gravitates naturally to considering assurance, or audit, and reporting more generally and so the opportunity is taken to consider these broader issues. Some reflection on the more general capabilities of the external assurance function is particularly appropriate given the recent global financial and economic meltdown. While the role of auditors in the current financial crisis has not yet, at the time of writing, been the subject of extensive discussion either in the professional and business media or in academic literature, it seems only a matter of time before cries of ‘where were the auditors?’ are heard.
Thus, the present report is concerned with the first stage of a two stage research project on both the immediate issues surrounding management commentary as well as wider assurance issues. This first stage investigates the perceptions of corporate report users, both investors and other stakeholders. The second and final stage will be the subject of a separate research report and will identify the response of external auditors, as well as the appropriate regulatory authorities, to the concerns and views of users.

Development of narrative corporate reporting

The past century has seen much growth in the scale of annual corporate reports issued by companies and other major organisations, within both the UK and elsewhere. At the same time, the nature of report content has evolved continuously. Initially, both the nature and the scale of change were modest, reflecting very gradually increasing statutory requirements. Thus, while the production of annual accounts has been compulsory within the UK since 1900; with the 1907 Companies Act requiring the filing of annual audited balance sheets by public companies, companies have been required to submit profit and loss accounts to shareholders only since 1929. The extent of statutory requirements was greatly extended by the Companies Acts of 1948 and 1967.

From the mid-sixties onwards, annual corporate reports grew rapidly in size (Lee, 1994) although Marino (1995) suggested that this increase in size had not been sustained. The significant increase in size of typical annual reports during this period resulted from both mandatory (see e.g. Bartlett and Jones, 1997) and voluntary initiatives. Voluntary disclosures increased greatly as corporate reports increasingly became to perform a public relations function (Stanton and Stanton, 2002). In particular, the burgeoning corporate social reporting (CSR) agenda was a major theme underpinning the voluntary disclosure growth during this period although initiatives such as the US Jenkins Report (AICPA, 1994) pointed the way towards the possible development of a broader (‘business’ rather than purely ‘financially’ orientated) reporting paradigm.
Contemporary developments and position

Management commentary

These voluntary developments in reporting have been reflected in both recommendation and mandate on the part of standard-setting and other regulatory authorities. In recent years, perhaps the most important, albeit ‘semi-official’, seal of approval accorded narrative corporate reporting, has been the publication by the IASB of the discussion paper Management Commentary (IASB, 2005) and a resultant exposure draft with the same title (IASB, 2009). These potentially highly significant publications are the visible output to date of the IASB management commentary project set up in October 2002. The starting point for this project was to work towards ‘the eventual inclusion in IAS 1 Presentation of Financial Statements (IASB, 2003) of a requirement to prepare a narrative report, coupled with non-mandatory implementation guidance on what ought and ought not to be included in such a report’ (IASB, 2005, p.3). The IASB (2005) defines management commentary as follows:

Management commentary is information that accompanies financial statements as part of an entity’s financial reporting. It explains the main trends and factors underlying the development, performance and position of the entity’s business during the period covered by the financial statements. It also explains the main trends and factors that are likely to affect the entity’s future development, performance and position. (IASB, 2005, para.19)

The IASB (2009) has redefined management commentary in its 2009 exposure draft, as follows:
A narrative report accompanying financial statements prepared in accordance with IFRSs that provides users with historical and prospective commentary on the entity’s financial position, financial performance and cash flows, and a basis for understanding management’s objectives and its strategies for achieving those objectives. (IASB, 2009, p.17)

‘Management commentary’ is thus the generic term for a form of narrative reporting that for some time has been promoted, and in some cases required, in several major national accounting jurisdictions including Canada, Germany, the UK and the USA. Germany has the longest requirement for management commentary type reporting with a requirement to produce business reports dating back to 1931. The German approach to management commentary has a particular emphasis on risk reporting and there has been a German accounting standard on risk reporting since 2001. Canada and the USA use the term ‘Management Discussion and Analysis’ (MD&A) to describe management commentary reporting and the history of the MD&A goes back to the 1970s. The production of an MD&A has been mandatory for US-listed companies for over twenty years. The IASB has a clear international focus and the research that is the subject of the present report has been executed within the UK.

UK background

Within the UK, the development of the ‘Operating and Financial Review’ (OFR) – to some extent mirroring the earlier development of the MD&A in the US – was a major landmark in corporate reporting, resonating with both CSR and ‘business reporting’ initiatives. The OFR originated as a voluntary document in 1993 (ASB, 1993). Its purpose was to encourage the provision of additional information on the main factors underlying financial performance and position. The establishment of
the voluntary OFR coincided with growing concerns about the way in which information about companies reaches the financial markets and with an announcement of a review of the guidelines on disclosure of price sensitive information. Weetman et al. (1994) highlighted doubts about the effectiveness of a voluntary approach, recommending that:

...the OFR should as soon as is reasonably practical, have the backing of regulation and that regulation might be by way of Stock Exchange rules, a suitably rigorous audit, or both. (p.ix)

Growing perceptions of the status and importance of the OFR strengthened the view that voluntary approaches in this area were inadequate, culminating in 2002 with UK government proposals for a statutory OFR (DTI, 2002). By 2000, the Company Law Review Steering Group (CLRSG, 1999, 2000a, 2000b) had decided against continuing with a voluntary OFR under the auspices of the ASB largely due to the patchy compliance with the 1993 Accounting Standards Board (ASB) statement in corporate reports. It was considered that companies that were ‘economically significant’ should be required to prepare an OFR.

Statutory regulations issued in 2005 (HMSO, 2005) were intended to make the production of an OFR compulsory for UK listed companies with this statutory OFR being established as a separate component of the financial statements. The requirements included a comprehensive and balanced analysis of the business, consistent with both size and complexity in terms of:

- the development and performance of the business during the financial year under review;
- the position of the company at the end of the year;
the main trends and factors underlying the development, performance and position of the business during the financial year; and

the main trends and factors likely to affect the future development, performance and position prepared so as to help members assess the strategies adopted by the company and the potential for such strategies to succeed. (HMSO, 2005, Schedule 7ZA, 1)

Originally, the ASB proposed that the OFR should provide a framework for directors to discuss and analyse the performance of the business. Some forward-looking information was to be included in the OFR (ASB, 1993) in order that users would be able to assess the future potential of the business. Work by Weetman and Collins (1996) indicated that OFRs commonly contained little by way of the forward-looking information that is arguably central to the spirit of the report. The most common reason argued for this omission was the liability implications of inaccurate forecasted information. There was no ‘safe harbour’ provision in the UK similar to that in place in the US although the UK government has now made provision for a similar limitation of directors’ liabilities in the ‘business reviews’ necessary to comply with the EU Modernisation Directive.

Statutory regulations (HMSO, 2005) came into force in 2005, requiring quoted UK companies to prepare an OFR for financial years beginning on or after 1 April 2005. Quite unexpectedly, these proposals were abandoned in November 2005, on the grounds of reducing the administrative burden on business, on the initiative of the then Chancellor of the Exchequer, Gordon Brown. Following the decision not to require a statutory OFR, the UK adopted a requirement, under the Companies Act 1985, for an ‘Enhanced Business Review’ (EBR); currently this requirement essentially governs narrative reporting for all but the smallest of companies, with the EBR required for all reporting entities within corporate groups except those in the ‘small’ category, in accordance with the EU Accounts Modernisation Directive (EU, 2003).
Introduction

The UK thus continues to mandate the statutory approach in a more modest way than it would have done had the proposed OFR legislation passed into law (see Burns and Paterson, 2007). However the vigorous opposition that has been articulated in response to the abandonment of the OFR and the major IASB initiative on management commentary, taken together with an increasing awareness of the importance of narrative reporting generally, suggest that future reports are likely to assume a more substantial form than that of the relatively modest business review. Although the main focus of the present research is on the assurance aspects of management commentary, the opportunity is also taken, therefore, to investigate stakeholder perceptions as to the present and future significance of the management commentary itself.

Assurance on management commentary

The developments in narrative reporting discussed in the previous section prompt consideration of the associated assurance, if any, expected by users. The IASB (2005) suggests that in due course it may be appropriate for the International Auditing and Assurance Standards Board (IAASB) to address ‘the attestation of management commentary’ (para.194). In the UK, the non-mandatory OFR did not of course require to be audited although academic research (e.g. Weetman et al., 1995) highlighted some user demand for assurance.

The proposed legislation of 2005, however, inserted a new audit requirement in the 1985 Companies Act. This was downgraded, prior to the legislation being abandoned, to what was essentially a consistency check; due partially to pressure from the auditing profession. Auditors were required to state in their report:

(a) whether the information given in the OFR was consistent with the accounting information; and
(b) whether any matters were noted which were inconsistent with the information given in the OFR’ (HMSO, 1985, as amended, section 235, 3a).

These very modest proposals, however, are not necessarily a guide as to future policy. Further developments in narrative reporting may come, depending upon the attitudes of legislative and regulatory bodies, with associated assurance at various levels or, indeed, with none.

For the auditing profession, this possible extension, at various levels of rigour, of the scope of external assurance may constitute either an exciting opportunity or a serious threat. A focus on management commentary may be the catalyst needed for a radical reformation of external assurance with a more obvious focus on adding value to client organisations. Alternatively, arguments expressed to the effect that auditors are not equipped presently with the necessary skills to audit management commentary, when taken to their logical conclusion, may imply that the future of the traditional financial audit is unclear.

Should the Management Commentary exposure draft (IASB, 2009) result in mandatory reporting requirements then debate on the extent and scope of assurance is likely to become an important issue. This is the primary motivation for this research report.

More general assurance issues

Stakeholder views regarding assurance on management commentary prompts wider reflection on: perceptions as to the content and usefulness of audit reports generally; and the perceived robustness of the external audit function.

There has been some discussion (e.g. Manson and Zaman, 2001) in the academic literature about ways in which external audit reports might be enhanced and there is evidence (e.g. views received by the Financial Reporting Council (FRC) in response to its paper ‘Promoting Audit Quality’) of some support by user groups for changing the format
of audit reports. As a result, the UK Auditing Practices Board (APB) issued a discussion paper (APB, 2007) on possible changes to standard audit reports. Most of the changes discussed are modest although the most radical concern possible innovations such as references to uncertainty, future risk and material areas of judgment in audit reports with the possibility of these becoming ‘tailored’ and company-specific rather than ‘standardised’ as at present. These possibilities may have particular relevance to assurance on management commentary as they resonate with earlier calls (e.g. Hatherly, 2003) for audit reports focused specifically on management commentary (or the UK OFR). Debate on audit report content may also prompt consideration of the perceived rigour of the audit itself and the utility derived from it by stakeholders.

**Contemporary economic and financial crisis**

These more general issues appear to be worth specific consideration in the context of the contemporary global economic meltdown characterised by almost systemic failure in the financial sector. The coincidence of the present research with the contemporary financial crisis, while largely fortuitous, has created an opportunity to explore user perceptions of the assurance function at a significant time in corporate history. The use of ‘fair-value’ accounting, particularly in conditions of market instability and within the financial sector, has been criticised, especially for its reliance on subjective valuation models (see e.g. ACCA, 2008). This suggests that there may be a potential role for management commentary-type reporting in elucidating the subjectivities of fair value accounting and the ‘parameters where profits and losses are struck’ (ACCA, 2008, p.5). Put more simply, there may be a demand, particularly from less ‘expert’ users, for more accessible reporting in order to illuminate the complexities of IFRS-based financial reporting.

These more general dimensions of the present research may resonate with the present ‘state of the nation’. At the time of writing, even avowed defenders of capitalism acknowledge a need for critical change
in the way that markets are operated and for robust justification as to why ‘the market will remain the least best arbiter of advanced societies’ (Hastings, 2009, p.30). At a time when there are suggestions by sober commentators, such as Hastings, of serious potential threats to not just the economic, but the political stability of the western democracies it may be that there is room for debate about the contribution which a reformed assurance function might bring to the enhancement of corporate accountability.

**Structure of report**

In the remainder of the report chapter two reviews the available literature on the development of narrative corporate reporting and on management commentary in particular, on the associated assurance and on more general assurance issues relevant to the research project. Key issues are identified from the literature and from these the objectives for the empirical work are derived.

Chapter three explains the research methods. Two postal questionnaire surveys were followed by a series of in-depth interviews with members of key stakeholder groups in order to explore the research objectives, and the responses to the questionnaire surveys, in greater depth.

Chapters four to six analyse the research results from both questionnaire surveys and interviews. Chapter four deals with stakeholder perceptions as to the significance of management commentary itself; chapter five investigates views on providing assurance of management commentary. Chapter six explores the perceptions of the research participants as to the usefulness of external audit reports and how this value might be enhanced as well as views on the value of the contemporary audit function generally.

Chapter seven summarises the conclusions from the research and sets outs policy recommendations and objectives for the second stage of the research study.
Chapter 2: Literature Review

Introduction

The focus of this report is on the assurance of management commentary and other narrative reporting. It is necessary, however, to consider the assurance issues within the broader context of corporate reporting requirements and practice in this area. Consequently, this chapter first reviews the relevant literature on corporate reporting before dealing with that on assurance.

Corporate reporting

Management commentary is part of a general movement towards the disclosure of more qualitative information by corporations. Much of the drive towards narrative reporting has derived from the US Jenkins Report (AICPA, 1994) which proposed an influential model for business reporting. Periodic corporate reporting has traditionally focused on the quantitative dimensions of financial information, emphasising the profit and loss account, balance sheet, cash flow statement and notes. This emphasis on historical financial measures has contributed to a ‘business reporting expectations gap’ (Beattie, 1999, p.11).

Over the past decade, a range of different literature (e.g. AICPA, 1994; FASB, 2001; Beattie, 1999) has highlighted that corporate reporting to the financial markets is likely to take on increasingly a narrative, as opposed to a numerical, character. This move to business reporting, it has been argued, will constitute an ‘inevitable change’ (Beattie, 1999) and financial reporting will constitute only one part of
the reporting package. There are several reasons for this. The typical reporting entity is no longer a relatively stable manufacturing company, with largely tangible assets, but rather an organisation with an increasing proportion of intangible assets. In creating value, intangibles such as brands, relationships, people, systems and knowledge are of increasing importance to contemporary companies. Since these intangibles are largely ‘off balance sheet’ narrative disclosures are necessary to enable users to understand the dynamics of the business. Furthermore, such enterprises are likely to be operating in a dynamic environment characterised by political, economic and technological change. Purely financial reporting is likely to capture an increasingly small proportion of the available information-set for such entities (see Lev and Zarowin, 1999). The OFR in the United Kingdom, the MD&A in the USA, and the IASB Management Commentary document itself, may be conceptualised as modest first-steps towards a narrative-focused business reporting model.

United States

In the US, the MD&A developed from a focus on quantitative measures – ‘a mechanistic commentary in which issuers simply described percentage variations between line items’ (Bagby et al, 1988, p.73) – to a more evaluative document in the 1980s in order to meet investor and analyst demands. There is mixed evidence however as to how useful users rate MD&A information. Epstein & Pava (1993) found that the MD&A was not perceived as being particularly useful to US shareholders. Rogers and Grant (1997), on the other hand, found that the narrative sections of annual reports, including the MD&A, provided the greatest single source of information for sell-side analyst reports (the financial statements had, in contrast, limited input).

In contrast to the US approach, the ASB in the UK has been reluctant to regulate and the OFR originated as a voluntary document (ASB, 1993) in order to encourage open, flexible reporting by companies
on matters concerning their operations, finances and shareholder return and value. Collins et al. (1993), however, in comparing a sample of US-listed UK companies with a sample of US companies, found sufficient variety in structure in both countries to state that ‘the MD&A report is serving the purpose of encouraging a free-ranging design of report within a general prescription of content’ (p.165). UK MD&A reports, however, were found to be more flexible and offered more voluntary and forward-looking information than the US reports with the authors suggesting that US companies were possibly restricted by SEC regulations although this was ‘born of familiarity and repetition rather than of the rules themselves’ (p.172). It appeared that within both countries, companies were able to design reports tailored to their own specific requirements and reports did not exhibit a strict uniformity of structure. Thus the academic evidence does not suggest that a regulatory approach along the lines of the US is, in itself, detrimental to user needs.

**United Kingdom**

In the UK, the narrative components of corporate annual reports were once limited to the directors’ report and the chairman’s or chief executive’s statement. Typically, however, a wide range of different narratives now accompany the traditional financial statements, perhaps reflecting the voluntary approach that has been adopted within the UK. With the advent of the non-mandatory OFR (ASB, 1993), corporate governance initiatives (FRC, 2006), and social, ethical and environmental reporting (Gray et al. 1997), the extent of narrative reporting has grown impressively. Deloitte and Touche (2005) indicated that the proportion of UK listed companies’ annual reports consisting of narrative reporting had increased steadily and was now standing at around 60% for the top 350 companies by market capitalisation. Deloitte (2007) noted that in the top 350 group of UK companies the narrative reporting section had increased between 2005/06 and 2006/07 from an average of 70 to 77 pages.
A number of UK studies have explored the perceived usefulness of the narrative components of annual reports and the standard-setting approach adopted. Weetman et al. (1994) found that analysts and professional investors welcomed the OFR initiative but that they had some misgivings about the voluntary approach being taken by the ASB, preferring a regulation-backed OFR. These findings are interesting given the earlier findings of Collins et al. (1993) to the effect that a regulatory approach was not necessarily inconsistent with the expression of corporate individuality.

Bartlett and Chandler (1997) reported strong private shareholder preference for the narrative sections of annual reports with 84% reading the chairman’s statement, 83% the financial summary, 67% the chief executive’s review, and between 62% and 67% the review of operations and financial review sections of the directors’ report. These figures compare with 68% reading the profit and loss account and 59% the balance sheet. There was less preference for the corporate governance information however – 41% reading the board and corporate matters section, and 24% reading the corporate governance section itself.

A later survey by Beattie and Pratt (2002) examined the preferences of expert users, private shareholders, finance directors and audit partners for disclosures in corporate narrative reports. Whilst all groups rated financial items such as operating income and earnings most highly, auditors favoured management commentary-type information items, the authors reporting (p.71):

...audit partners, because of their role and responsibilities, find comparisons of current performance with benchmarks and information on sources of business risk particularly useful and it seems clear that auditors find MD&A information items very helpful in performing the analytical review process associated with the attest function.
The voluntary nature of the initial OFR guidance implied a danger of, at best, selective compliance with the proposals and a survey by Weetman et al. (1995) of 97 of the FTSE-100 companies found 16 of them complying with the spirit of the ASB (1993) OFR guidance ‘and providing a significant addition to the understanding of the annual report’ (p.16); 24 companies complied with the spirit of the guidance in ‘a substantial proportion of the areas covered’; 21 complied with the spirit in ‘at least half of the areas covered’ and met the main requirements overall; 30 companies met the technical requirements of the guidance but did not demonstrate compliance with the spirit of the guidance; the remaining six companies met neither the technical aspects nor the spirit of the guidance.

A follow-up study (Weetman and Collins, 1996) found some improvement, with 21 companies in the top category and just two in the bottom. This study also involved interviews with 14 finance directors from the FTSE-100, spanning all categories of compliance. The main findings were that these preparers wanted to retain control over the style and content of the OFR and did not want it to become as prescriptive as the US MD&A. Arthur Andersen (1996) reviewed compliance with the ASB voluntary statement two years post-implementation and found 80% of the largest listed companies were doing a reasonable job of publishing OFRs; by 2000 this had risen to 94% (Arthur Andersen 2000).

By way of partial contrast, however, Beattie et al. (2002), reviewed the narrative sections (including the OFR) of the annual reports of 11 UK listed companies to identify the extent to which the content matched the recommendations of the Jenkins Report (AICPA, 1994), noting a wide variety of coverage, but finding that:

...operational, analytical, forward-looking and strategic topic categories, which are regarded to be of critical importance, are much less common... totalling only 24% of all disclosures. (p.xiii)
Beattie *et al.* (2002) thus found relatively poor coverage of the Jenkins model and recommended that companies increase the quality of their disclosures and widen the range of topics covered.

A study of the unaudited narrative sections of the annual reports of football clubs found a heavy bias towards positive commentary and indications of selectivity and ‘image management’ in disclosure (Morrow, 2005). Morrow welcomed the OFR proposals then current, as a means of regulating narrative reporting and ensuring more balanced presentation.

Rutherford (2002) examined management commentary in a UK context comprehensively. Rutherford (2002) provided an overview of the rapid development of narrative reporting from the ASB’s 1993 OFR statement to the 2002 Government White Paper (DTI, 2002) proposing a statutory OFR. Rutherford conducted a review of 419 listed companies’ 1999 annual reports (from the Times UK 1000); of these, 190 or 45% produced an OFR either as a combined operating and financial review or as two separate reports; 147 or 35% offered a financial review only; 23 or 5% an operating review only, and 59 or 14% had no OFR or similar. Sixty-four companies that produced a combined OFR were examined in further detail to identify design issues; Rutherford noted the blurring between OFR content and information elsewhere in the report and suggested that the use of graphics and softer information within the OFR would impact on user perceptions of the status of the material. A deeper content analysis was carried out on ten OFRs; the author found (p.61) that companies were generally resisting the ‘more innovative’ aspects of the ASB guidance such as reporting on business dynamics or the future prospects for the company. The Rutherford study made numerous recommendations including further trials of the proposed audit review process; these recommendations, however, were not put into practice.

In a more recent survey, Company Reporting (2004) reviewed OFR practice by the FTSE-100 and other large companies and still found a wide variety of forms and content. Fifty-five per cent offered a combined
OFR, but 7% produced no OFR information. The government proposal for a statutory OFR was not welcomed by the authors who believed that it would only encourage a box-ticking mentality. They were also concerned by the overlap between OFRs and corporate social responsibility reports. Company Reporting (2004) found that ‘disclosures in respect of future prospects tend to be opaque and non-specific’ (p.4) but 75% of OFRs mentioned risk, in particular treasury risk.

With OFRs having only a voluntary status, Deloitte (2007) noted a decline in the number of companies producing formal OFRs from 41% of all listed companies surveyed in 2005 to 20% in 2006 to 10% in 2007, suggesting that the reason for this was possibly to avoid possible non-compliance with the ASB Reporting Statement (ASB, 2005).

The IASB Management Commentary discussion paper (IASB, 2005) suggested that, to meet management commentary objectives an entity should disclose information on the nature of its business, its objectives and strategies, its key resources, risks and relationships, its results and prospects and its performance measures and indicators. Deloitte (2007) commented on each of these areas in the UK. Although the vast majority of companies surveyed included comments on their products and services, the structure of their businesses, industries and markets, this was sometimes included in introductory statements at the start of the annual report rather than in the OFR. Only 40% of companies surveyed included information on legal and regulatory matters and key dependencies (Deloitte, 2007, p.12). There was a wide variation in quantity and quality of information disclosed on objectives and strategy and over 27% of companies said nothing about objectives. Disclosures on strengths and resources also varied widely with very few companies including a comprehensive discussion on key strengths. Surprisingly, very few companies included comments on intangible assets, even if they appeared on the balance sheet. Discussions tended to concentrate on brand strength, employees and research and development (Deloitte 2007, p.32). In 2007, 64% of the companies which participated in
the survey, disclosed information regarding risks in the OFR. This represented a reduction from 2006’s 74% but this was mainly because companies were tending to make risk disclosures within the EBR instead of the OFR. However, the range of risks covered appeared to be wider, with 84% of companies commenting on risk in the OFR discussing non-financial risks such as strategic, commercial and operational risks (2006: 61%). It was also noteworthy that although there was a wide variety of disclosure in terms of quantity and quality most companies disclosed their policies for managing their principal risks (84%) and a description of risks that could impact on future performance (100%). In 2007 100% of companies surveyed included a discussion of trends in performance during the current year and 97% commenting on trends likely to impact on future performance. In relation to the final area, the proportion of companies including Key Performance Indicators (KPIs) in their OFR increased from 45% in 2006 to 79% in 2007. This increase was particularly pronounced in the top 350 companies with 91% including KPIs, principally because of the EBR requirements, which made it mandatory to disclose financial and non-financial KPIs (Deloitte, 2007, p.20).

Roslender et al, 2008 carried out a critical review of the watering down of the Government’s plans for the OFR. The authors contended (p.14) that the final Statutory Instrument (HMSO, 2005) made the OFR ‘less discursive and more factual’ and that by specifically addressing it to shareholders, the needs of other stakeholders are not likely to be addressed. Solomon and Edgley (2008) suggest that the abandonment of the statutory OFR represented a lost opportunity to integrate social and environmental reporting into mainstream reporting. Roslender et al. (2008) conclude that more time should have been spent in shaping the OFR proposals and the associated assurance role in order to make the exercise more meaningful for both companies and stakeholders; instead, the rush to compromise and legislate may have resulted in directors
seeing ‘the exercise as a regulatory burden rather than an opportunity to instigate dialogue with their stakeholders’ (p.15).

In summary, the UK picture is one of a sustained increase in the level and scope of disclosure. There are, however, a number of potentially limiting factors. The voluntary nature of the OFR up to April 2005, while it reduced the risk of box-ticking and provided flexibility for directors to focus on issues critical to their own organisation, resulted in a wide diversity of practise. While mandatory requirements relating to management commentary reporting have existed continually in the UK since April 2005 these are now restricted to the business review (‘enhanced’ since October 2007); the requirements relating to the production of a statutory OFR having been abolished from 1 April 2006. There is considerable overlap between the content of management commentary, OFR, CSR reports and EBRs, in areas such as risk disclosures and objectives and strategy and there is evidence of wide variation in the quantity and quality of information disclosed. Arguably the UK picture suggests the need for a more coordinating strategy aimed at making reporting more meaningful to users. However, in general it appears that users welcome and see a need for narrative reports (e.g. Neveling, 2006) which bodes well for the future of Management Commentary (IASB, 2009).

Assurance on management commentary

Introduction

Developments in reporting highlight the issue of the associated assurance that may be expected by users and ‘offered’ by the audit profession; Management Commentary (IASB, 2005) itself suggests that the question of assurance on management commentary reporting is an open question awaiting investigation (paras.186-194).
A lack of existing research on the assurance of narrative disclosures may reflect the comparative unimportance of these in past corporate reporting. However, a growing emphasis on alternative corporate reporting paradigms in the nineteen-nineties led the US Elliot Committee (AICPA, 1997) to highlight a need for research into the evolving assurance needs of users. The reporting literature highlights the blurring between the management commentary content and information contained elsewhere in annual reports and Rutherford (2002) pointed out that an audit of the OFR would necessitate a clearer delineation of audited and non-audited material. If auditors were to be given responsibility for reporting on OFRs, there would also have to be a clear prescription of OFR content to prevent directors from making disclosures in the directors’ report or some other part of the annual report not subject to audit. Auditors involved in the trial of the OFR for the Industrial Society (see Rutherford, 2002) noted the wide variety in style and content, the tendency for ‘boilerplate’ language, possible confusion and overlap with other narratives as well as the need for guidance. Roslender et al. (2004) examined the Department of Trade and Industry’s Accounting for People initiative which recommended reporting human capital measures in the OFR. Roslender et al. (2004) outlined several concerns over the ability of the accounting profession to report on more qualitative issues such as human capital management and questioned the viability of the OFR as a vehicle for corporate and social responsibility and ethical and environmental reporting. Roslender et al. (2008) highlighted that the likely multi-authorship of management commentary may mean that responsibility may be difficult to trace, creating assurance difficulties.

A recent publication by the Institute of Chartered Accountants in England and Wales (ICAEW, 2008) provides a useful summary of the present UK position on the assurance of non-financial information arguing that while demand for assurance remains limited, it appears to be a developing area.
Alternative forms of assurance

There are various forms of assurance – consistency, process and content – that provide alternative frameworks for management commentary assurance. In the assurance context, content and consistency (the approach long adopted in respect of the UK directors’ report) are familiar concepts. The fundamental distinction between the content and consistency approaches is well known and was discussed, for example, in a DTI memo of October 2005 to the then Chancellor on the likely costs of auditing the (then) proposed statutory OFR. Process is less familiar but was a feature of the assurance requirement for the proposed statutory OFR in the UK; this included a requirement to opine on whether or not ‘the directors have prepared the review after due and careful enquiry’.

Defining each of these forms of assurance is not straightforward and there are a variety of possible interpretations. Consistency is the most straightforward and may be articulated in terms of whether the information given in management commentary is consistent with that given in the entity’s financial statements or in terms of whether any matters have come to the attention of the auditors, in the performance of their functions, which are inconsistent with the information given in management commentary (see DTI, 2004, Annex A, paragraph 8), or otherwise misleading. Process may be defined in terms of whether the procedures followed in producing management commentary are designed to ensure that the content is, where relevant, truly and fairly stated and is understandable, relevant, supportable, balanced and comparable (see IASB, 2008, p.9) over time. Content may be expressed in terms of identifying whether the content of management commentary is, where relevant, truly and fairly stated and is understandable, relevant, supportable, balanced and comparable over time. Such an objective, however, may be problematic in the context of management commentary material that consists primarily of subjective opinion rather than matters
of fact. The subjectivity of much management commentary content may make it impossible for auditors to execute completeness checks and it has been argued that over-reliance on ‘management representation letters’ may result. There are, therefore, a variety of possible approaches, even within each distinct form of assurance as detailed above. The issue of whether audit reporting should take place in positive, negative or exceptional terms is also relevant (see Hatherly, 1997).

A US study by Bagby et al. (1988) noted that while there was then no assurance requirement for the MD&A, auditors were expected to read it and discuss with management any material inconsistencies with the financial statements. The authors warned that the ‘safe harbour’ rule put in place by the SEC to encourage forward-looking information, still posed litigation risks for companies and auditors and advised caution when making projections. They also warned that if MD&A reports were to be audited in the future, guidance would have to engage with the more qualitative areas ‘less susceptible to precise verification. This creates significant slack in oversight by auditors, the SEC, analysts, investors and the markets’ (p.96).

ASB (2005) states that directors may choose to include a statement in the OFR that users should treat forward-looking information with caution, and explain the underlying uncertainties. If such statements were made, auditors might be able to offer a form of assurance helpful to users, without exposing themselves to undue risk. In their article examining the very recent history of narrative reporting within the UK, Burns and Paterson (2007) commented unfavourably on the reduced rigour attached to assurance of UK narrative reporting resulting from the retreat from a statutory OFR in 2005. In summary, then, there are various approaches which might be adopted to the assurance of management commentary.
Attitude of the audit profession

The dominant attitude of the UK profession to the audit of management commentary may be characterised as being at the cautious end of the spectrum, reflecting the forward-looking and subjective nature of much management commentary information as well as potential liability considerations. It may be, however, that the recent decision of the UK government to limit directors’ liability for erroneous forward-looking information to that which is misleading or dishonest (Anon, 2006) has implications for auditors’ willingness to engage with this area. An audit of content has been argued by the Institute of Chartered Accountants in England and Wales (ICAEW) to be impractical due to the future-oriented nature of much relevant information (ICAEW 2004). However while arguments have been articulated by ICAEW (2004) for an audit, based on clear reporting guidelines, of consistency and of process, the Institute of Chartered Accountants of Scotland argued that the role of the auditor should be limited to a consistency check only (ICAS, 2004):

The type of work required to make any judgement on the adequacy of the OFR is of quite a different type to that normally carried out retrospectively in an audit... it is also aiming at much wider set of inputs to the process... some of which may lie outside the auditors’ competence to comment upon...

This statement assumes that future audit assurance will reflect the current status quo and be uninfluenced by changing corporate reporting. Similarly, the executive director of the UK Auditing Practices Board stated that ‘we hope the situation won’t be too difficult for auditors since the requirement for auditors to consider whether directors had prepared the OFR after due and careful enquiry has been dropped’ (Anon, 2005, p.12). These opinions reinforce the impression of reluctance on the
part of significant segments of the audit profession regarding the scope and extent of assurance. However there are signs of more adventurous professional attitudes. Guidance issued by KPMG for preparers of the new UK business review acknowledges that future-orientated information does not necessarily preclude verifiability. Auditors should ‘ensure that any forward-looking statements are accompanied with the source of the information, and the degree to which the information is objectively supportable’. (Copnell, KPMG, attributed in Perrin, 2006, authors’ emphasis)

**Business risk auditing**

While some sections of the audit profession appear reluctant to get significantly involved, an emphasis on risk in management commentary reporting (e.g. ASB, 2005, paras.50-54; IASB, 2005, paras.122-131) resonates with past developments in external audit methodology; in the late 1990s each of the large audit firms implemented its own proprietary brand of an audit methodology grounded explicitly in business risk. While debate exists over the motives for introducing business risk auditing (see e.g. Jeppesen, 1998; Knechel, 2007; Robson et al., 2007), its concern with business risk appears to make it a relatively robust platform for auditor engagement with the risk disclosures in management commentary that may be crucial to making management commentary assurance valuable to users.

Admittedly, there is doubt about the extent to which business risk auditing led to a substantial engagement with business risk on the part of external auditors (see Fraser and Henry, 2009) and, since then, there has been some retreat from business risk auditing by the profession with it being at least partially superseded by a discourse placing emphasis on ‘audit quality’ and compliance testing (Khalifa et al., 2007). It seems reasonable to assume, nevertheless, that the professional experience with
business risk auditing may help auditors to engage with the difficulties involved in meaningful management commentary assurance.

Furthermore, the introduction of business risk auditing was instrumental in the introduction of a series of international auditing standards with a professed business risk orientation. These standards applied to UK audits of accounting periods commencing on or after 15 December 2004 and should have ensured more explicit consideration of the impact of business risks and, arguably, higher quality audits (see Barbour, 2005). These developments could help to provide a platform for management commentary assurance going beyond consistency reviews.

Current audit methodologies, with an emphasis on understanding the risks of the client business, suggest synergies with assurance on management commentary which has a focus on the reporting of risks. The potential for external auditors conducting a meaningful evaluation of business risks invites investigation. This resonates with suggestions to the effect that the contemporary audit is not to do with understanding the business but with checking numbers in the form of increasingly complex IFRS-based financial reporting. At the 2006 National Auditing Conference of the British Accounting Association, Ian Percy, Chairman of the Companies House Steering Board and director of several major companies, suggested that several users, e.g. banks, were considering putting in their ‘own’ auditor because of these perceived deficiencies.

Relevant requirements and guidance from professional bodies

While there is, as yet, no professional guidance, mandatory or otherwise, on management commentary assurance per se, there are various relevant professional pronouncements on related reports. These reflect largely the cautious professional attitude identified in the previous section.
The current professional pronouncement of most relevance to assurance on ‘management commentary’ is ISA 720 *The Auditor’s Responsibility in relation to Other Information in Documents Containing Audited Financial Statements* (IAASB, 2009). This standard, which applies to accounting periods commencing on or after 15 December 2009, is a revision of the preceding ISA 720 *Other Information in Documents Containing Audited Financial Statements* (IAASB, 2004). In revised form, the standard continues to exemplify the attitude of caution exhibited currently by the audit profession. In essence, the standard takes a consistency approach with the auditor’s only responsibility being to read the non-financial statement information in order to identify inconsistencies with the financial statements themselves. There is some provision for action by the auditor – e.g. inclusion of explanatory paragraphs in the audit report, or in more serious cases, seeking legal advice or informing those charged with the governance of the entity.

Thus the revision of the standard is far from radical; for the most part, the ISA has merely been restructured in accordance with the IAASB amended *Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*, approved in September 2006. Neither in the original standard nor in the revision is any explicit guidance is given in relation to auditor responsibility for evidence collection. Interestingly, the UK APB added the following paragraph in its 2006 adoption of the original ISA:

*When the auditor reads the other information, the auditor does so in the light of the knowledge the auditor has acquired during the audit. The auditor is not expected to verify any of the other information.* (APB, 2006, para.4.1)
Prima facie, this gives further emphasis to the prevailing approach of passivity. The approach adopted by the IAASB is also reflected in other national jurisdictions. The current Australian standard (AAASB, 2006) is similar to ISA 720, apart from minor wording differences and rather less by way of explanatory paragraphs. There appears to be little commentary on these regulatory developments in professional literature. Von Wielligh and Butler (2007), however, provide a useful commentary on assurance implications of formalising management commentary.

United States

The United States requirements of auditors in this area appear much more onerous than those of the IAASB. The current standard (PCAOB, 2002), effective from 1 June 2001, appears to go well beyond IAASB requirements and the assurance work mandated by the IAASB appears minimal when compared with US requirements.

The standard (PCAOB, 2002) distinguishes between an examination and a less onerous review. A review consists principally of applying analytical procedures and making inquiries and does not include tests of accounting records that are deemed to be normally undertaken under an examination (para.08). The objective in an examination engagement is stated as the examination of MD&A to express an opinion by reporting whether:

(a) the presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC;

(b) the historical financial amounts have been accurately derived, in all material respects, from the entity’s financial statements; and

(c) the underlying information, determinations, estimates and assumptions of the entity provide a reasonable basis for the disclosures contained therein (para.05).
Practitioners seek to obtain reasonable assurance by accumulating sufficient evidence in support of the disclosures and assumptions, thereby restricting attestation risk to an appropriately low level (para. 28).

In order to achieve these objectives, practitioners are required *inter alia* to:

- obtain understanding of the rules and regulations adopted by the SEC for MD&A and management’s method of preparing MD&A (paras. 18-19);
- plan the engagement (paras. 42-48);
- consider relevant portions of the entity’s internal control applicable to the preparation of MD&A (paras. 49-58);
- obtain sufficient evidence, including testing completeness (paras. 59-64).

Thirteen different procedures are prescribed including, for example: comparing non-financial amounts to financial statements or other records, and obtaining public communications and external documents; consider the effects of events subsequent to the balance sheet date (paras. 65-66); obtaining eight suggested representations from management concerning responsibility for MD&A, minutes, post balance sheet events etc. (paras. 110-112); and forming an opinion on MD&A presentation (para. 67).

The opinion paragraph emphasises that:

*...the historical financial amounts included (in the MD&A) have been accurately derived, in all material respects, from the Company’s financial statements; and the underlying information, determinations, estimates and assumptions of the Company provide a reasonable basis for the disclosures contained therein.*
While the US requirements go far beyond what is required currently by the IAASB; these are restricted to the examination of present and past information and mandate a much more tentative approach for future information; practitioners are required to test this only for the purpose of expressing an opinion that the underlying information, determinations, estimates and assumptions provide a reasonable basis for the disclosures. They must also consider whether meaningful cautionary language has accompanied the forward-looking information (para.25). However, the more cautious approach to future information still remains more onerous than the IAASB requirements.

**User perceptions of the need for assurance**

There has been limited research on user perceptions of the need for assurance on corporate reporting other than the financial statements. The US Jenkins Committee (AICPA, 1994) highlighted that there appeared to be significant demand by users for assurance on both non-financial and forward-looking information. A telephone survey of professional investors suggested that 52% believed that auditors should provide some assurance on non-financial information and that 57% believed this regarding forward-looking information. A later UK postal questionnaire study (Beattie and Pratt, 2001) investigated the views of users, preparers and auditors on increasing the scope of assurance on corporate reporting and identified significant demand for assurance on the reliability of non-financial and forward-looking information.

A small amount of research has addressed the question of audit assurance on reporting of a more specifically management commentary nature and this is suggestive of some demand by users. In the UK, Collins *et al.* (1993) argued that even with voluntary management commentary reporting, as in the case of the UK OFR, users would require assurance and that the role and responsibilities of auditors would therefore have to be determined. The scope of assurance on the OFR was investigated by
Weetman et al. (1995); users were unhappy with merely a review of OFR content for consistency (as for the UK directors’ report) arguing instead for a rigorous audit although some speculated as to whether ‘new and different audit skills would be needed’ (p.55). Similarly, Roslender et al. (2008), in the context of the (now) abandoned proposals for the OFR, questioned the benefits that shareholders and other stakeholders would perceive to accrue from management commentary given the significant dilution of the audit requirement mandated by the UK government. Roslender et al. suggested that users would prefer a ‘true and fair’ opinion on the OFR, as for the financial statements, arguing that a bland audit statement on consistency with the financial statements did not fulfil the aim of ‘providing quality assurance’ (DTI, 2004, para.3.56). There may be a particular need for assurance on management commentary content if stakeholders perceive management commentary as having the same status as those sections of corporate reports presently audited.

The expectations gap

It is consistent with the academic literature that submissions to the IASB (IASB, 2006) on Management Commentary (IASB, 2005) exhibit diverse opinions on the desirability, or indeed the possibility, of management commentary assurance. The submissions demonstrate a clear lack of consensus; the most popular argument appears to be for a consistency review similar to that proposed in the UK. Some negative views are articulated in terms of the subjectivity of much management commentary content, the dangers of useless ‘boilerplate’ reporting, the inhibiting effects that assurance might have on the content of management commentary and the potential costs. These are challenges that any proposed assurance standard requires to deal with. One simple, and convincing, argument for assurance is the difficulty of otherwise ensuring the fairness of the ‘through the eyes of management’ philosophy adopted by the IASB:
Management commentary should not just be about what the management views as important because then there is room for self-interest and manipulation. If the objectives are to be achieved, management commentary needs to be audited especially if it is taken from management’s view. (University of Waikato, New Zealand).

Several submissions mention the need for an ‘effective audit regime’ (Standard Life Investments’) or the need for the IAASB to develop appropriate guidance.

These submissions to the IASB reflect views from industry, the audit profession and the investment community. There is some evidence suggesting other stakeholders might desire more robust assurance than that of a consistency review, for instance. Views of UK environmental groups on this issue include:

The role of the Auditor is very important here, as they should be able to give some assurance. I am not sure how auditors should shoulder this responsibility, however they are key. (Karen Moore, Scottish Business in the Community)

Auditors need to play a crucial role in the monitoring and process of information particularly the information which would have been disclosed in the OFR. For the public to understand how a company is treating the environment, it is probably necessary for it to be audited in detail. (Simon Thomas, Trucost)

Any mandatory OFR should, in my opinion, follow a common reporting framework i.e. contain similar criteria and be presented in a standard model. OFRs should also be independently verified/validated with verification exercises including sampling and challenging where appropriate of the data streams contributing to reported claims. (Derek McGregor, SEPA)

(Source of all quotations: Blair, 2006)
The literature thus suggests that an expectations gap may exist with demand on the part of users for management commentary assurance juxtaposed with reluctance by auditors to provide anything other than minimal assurance. This reflects a view that when new forms of reporting emerge the audit profession tends to react negatively. In the specific context of the enhanced disclosures required under Turnbull, Power (1997) refers to the ‘absurdly cautious nature of reporting in this area’ (p.56).

While there does not appear to be any research that has specifically investigated the existence of an expectations gap in respect of management commentary or narrative reporting generally, Porter and Gowthorpe's (2004) study of the expectations gap in New Zealand and the UK has some relevance to the present research. Porter and Gowthorpe (2004) found that a majority of auditees and users believed that auditors should report on the reasonableness of financial forecasts included in the annual report. Additionally, 68% and 50% respectively of auditees and users believed that auditors should report on the adequacy of client risk management procedures and on the reliability of information throughout the entire annual report. A key objective of the research, then, is to investigate the potential expectations gap for an area that has not been studied previously. The research also investigates whether or not an actual expectations gap exists in respect of the different levels of assurance provided for different components (e.g. directors’ reports, statements on corporate governance, interim or quarterly reports) of contemporary corporate reporting.

The emphasis on client business risks in some contemporary audit approaches may go some way towards bridging this expectations gap and provide the opportunity for auditors to increase the credibility of management commentary in a way that is helpful to users.

Assurance on management commentary might help to facilitate a reformation of the audit in a way that links the statutory audit with greater business understanding. In a UK context, Hatherly (2003) made
a suggestion for a new, additional audit report specifically focused on the OFR. In a call for auditors to add value to the business, Hatherly suggested that:

...if a fully fledged investment report is seen as a step too far for the moment, then a free form report by the auditors on the management’s operational and financial review (OFR) could be an intermediate step. (2003, p.34)

Such suggestions co-exist with concerns over contemporary audit quality. The chairman of the UK Financial Reporting Council’s Professional Oversight Board has suggested that ‘the quality of audits is under threat from a number of risks not being addressed by all [accountancy] firms in all audits’ (quoted in Jopson, 2005). Anecdotally, there appears to be acknowledgement that many recent audit failures reflect a lack of understanding of client businesses.

Calls for reformation of external auditing have come recently not just from academe but from the higher echelons of the profession. Thus a recent major study published by the accountability pressure group AccountAbility, and sponsored by PwC, argues that historic mechanisms for providing assurance may be no longer adequate and that ‘sound non-financial reporting and associated assurance is now understood as an important element of good corporate governance’ (Zadek et al., 2006, p.7). In the same context, a PwC representative suggests that the time is apposite for the profession to re-examine its societal role and that in the future ‘providing assurance that is limited to accounting information will fall well short of the mark’ (Phillips, 2006, p.11). Phillips (2006) suggests that a growing diversity of stakeholders will demand higher levels of assurance on better quality information and, in particular, on non-financial information. The submission of PWC (International) to the IASB (see IASB, 2006) on Management Commentary (IASB, 2005) is rather less radical:
...recommending that this area should be considered by the IAASB. We believe that at least in the short term management commentary should not be within the scope of an audit but auditors should report whether or not management commentary is consistent with the financial statements’. (Submission by PWC, International included in IASB, 2006)

Thus the rather negative views of some sections of the audit profession regarding management commentary assurance may not only represent a missed opportunity but, should they prevail, may raise question marks over the future of assurance should corporate reporting evolve as suggested, in response to stakeholder pressures. If there is significant demand by users for emerging business and non-financial reporting to be accompanied by meaningful assurance unwillingness by auditors to respond may lead to other providers filling the gap. (Non) developments in this area are paralleled by a similar scenario in risk and governance reporting; Power (2000) has opined that developments in the regulation of UK corporate governance are operating as a ‘Trojan horse’ (2000, p.20) as far as financial audit is concerned and that there are new potential sources for professional advice that may challenge the audit profession. The recent review of the Turnbull guidance on internal control recommended that no significant changes to the guidance were required and that there should be no expansion of audit responsibilities in relation to internal control and risk. More generally, unwillingness to respond to user demands for assurance on narrative information may affect the long-run credibility of the financial audit function. Beattie (1999) calls for research into the nature of the assurance that will be required in respect of future business reporting.

In summary, the present research is relevant to current policy-making debates about the future of corporate reporting and the concomitant assurance. As such the research has a clear public interest dimension and is of relevance both to the users of corporate reports and to the audit profession and its future development.
More general considerations: the value of audit reports and of external audit

Calls for assurance on the UK OFR or on management commentary (Hatherly, 2003), lead naturally to consideration of the value of external audit reports generally. Although past academic work (e.g. Innes et al., 1997) has indicated that the significant increase in the length and content of the standard audit report which took place in 1993 (APB, 1993) was of some limited value, there have also been calls for audit reports to be enhanced either by a more company-specific structure (Hatherly et al., 1998) or by the inclusion of more information as to the audit findings (Manson and Zaman, 2001). This academic work is echoed in the more radical of the suggestions made by the UK APB for enhancing the value of audit reports in its recent discussion paper (APB, 2007). That discussion paper has signalled the possibility of including more company-specific information within audit reports along the lines of, for example, French reports.

Consideration of whether or not information on audit findings should be included within audit reports prompts consideration of the value of the audit itself. There is a long-standing and quite voluminous ‘critical’ literature (two examples are Mitchell and Sikka, 1993; Sikka, Willmott and Lowe, 1989) which has questioned the ‘professionalism’ of external auditors and the rigour with which they carry out their work. Much of this literature questions the claims of the audit profession to be ‘independent’ (e.g. Sikka and Willmott, 1995). However, such critics are not restricted to academics and include those who can perhaps claim more legitimately to represent investors (see e.g. Richards, 2004).

Very recently (e.g. Sikka et al., 2009; Woods et al., 2009) attention has been paid to the role played (or not) by external auditors in the ongoing global financial and economic crisis and specifically in connection with the systemic failures which have beset the corporate financial sector. This recent literature highlights the complexities of
contemporary accounting practice, based on ‘fair’ values, for derivatives and other complicated financial instruments and suggests a need for these ‘problematic’ features of financial reporting to be signalled more clearly by auditors.

Summary

This chapter has surveyed the literature on management commentary and the role of auditors and can be summarised as follows:

- Current proposals on management commentary reflect a more eclectic view of corporate reporting than the traditional model. Future reporting to the markets is likely to concentrate not just on the financials but to increasingly incorporate broader business considerations.

- A variety of evidence – e.g. views expressed by a variety of stakeholder groups and the increasing complexity of financial statements based on contemporary international GAAP – suggests that narrative reporting of a ‘management commentary’ character may eventually partially supersede traditional financial reporting; at least for some stakeholder groups.

- These likely future developments raise the question of the assurance that may be demanded by users as well as that offered by the audit profession.

- There is much evidence – including the audit requirements for contemporary narrative reports – that suggest a cautious attitude on the part of the audit profession. The requirements in some geographies, notably the USA, are more onerous than those mandated by contemporary international standards although those more demanding requirements tend to take a minimalist approach to
assurance on future information. Nevertheless, some professional views support a more adventurous approach. It may be that a failure by the audit profession to respond to developments in corporate reporting will make its future role in this area problematic.

- Recent developments in external audit, and in particular, the development of methodologies grounded in business risk, may provide a platform for effective engagement with ‘management commentary’ type narrative reports incorporating disclosures on corporate risks.

- There is evidence from a variety of users of significant demand for assurance on ‘management commentary’. There appears to be the potential for an expectations gap in this area.

- Issues about assurance on management commentary highlight other related issues about the usefulness of external audit reports and about the value of the contemporary audit. These issues have a particular resonance at a time of financial and economic crisis.

These issues are examined in this report. The next chapter outlines the research methods used.
Research objectives and questions

The research focuses on user views and perceptions as to three broad but related issues:

- The value and importance of the management commentary and the factors that inhibit that usefulness;
- The need for external assurance to be provided on the management commentary and the extent and scope of the audit assurance that should be provided; and
- The degree of confidence in the present external audit process, the perceived usefulness of current external audit reports and views as to how the usefulness of audit reports might be enhanced.

The specific research questions (RQ) to be addressed are as follows:

**RQ1** How important is management commentary in enabling users to understand the business entity and what factors inhibit the usefulness of management commentary?

**RQ2** How important is it to provide external audit assurance on management commentary to financial statement users?

**RQ3** What form, extent and depth of audit assurance is most appropriate for management commentary and what would be the most appropriate reporting approach for the communication of this assurance?
RQ4 How confident are users in the present external audit process?
RQ5 How useful do users find external audit reports and what could be done to improve the usefulness of audit reports?

In order to address these questions a two-stage research approach was adopted. Firstly, questionnaire surveys were sent (both electronically and by post) to investors or their representatives (investment analysts, fund and investment managers, investment industry regulators and private shareholders) and to other stakeholders (including accountants in business, credit analysts, social and environmental groups, members of the Scottish parliament and professional accountants practising in a non-audit capacity). While an attempt was made to survey a representative selection of non-investor stakeholder groups, it was recognised that comprehensive coverage was impractical. In particular, no attempt was made to cover mainstream lenders as the research coincided approximately with the height of the 2008 financial crisis. Secondly, semi-structured interviews were conducted with individuals representing the various respondent groups.

**Questionnaires**

Two questionnaires were used. A detailed questionnaire was distributed to investors and a much shorter questionnaire was distributed to non-investor stakeholders. A principal feature of the shorter questionnaire was that it excluded more technical questions on the alternative possible approaches to the audit process and to audit reporting. The long and short questionnaires are available from the authors.

The investor questionnaire was divided into five sections. The first section consisted of two questions concerning the job title (or other identity) of respondents and the extent of their (self-perceived)
knowledge of corporate reporting. Section two comprised four questions on the importance and usefulness of narrative information in corporate reports generally and management commentary in particular. This was followed in section three by four questions that elicited respondent perceptions on the desirability of providing external audit assurance on management commentary and on what form such assurance might take. Section four contained five questions exploring the confidence of respondents in the external audit process, the usefulness of the present audit report and how investor confidence might be enhanced by changes to the audit report. The final section gave respondents the opportunity to provide any comments which they wished to make on the subject matter of the questionnaire generally and to express willingness to participate in the interview stage of the research project.

The stakeholder questionnaire contained five sections similar to those in the detailed questionnaire but the number of questions in each section was reduced significantly to focus specifically on the areas deemed to be relevant to non-investor stakeholders and to elicit as high a response rate as possible from respondent groups, some of whom could be assumed to be unfamiliar with corporate reporting and auditing.

Most of the questions in both questionnaires required responses on a 5-point Likert scale of 1 (agree strongly/very important/very confident/very useful/very desirable) to 5 (disagree strongly/very unimportant/very unconfident/useless/very undesirable). In addition, a ‘don’t know’ response category was included. Two questions required prioritisation of choices for the form of assurance on management commentary (most preferred/next preferred/least preferred).

Survey populations and responses

The investor questionnaires were distributed both electronically and by post. Both the UK Shareholders Association (who represent private shareholders) and the Securities and Investment Institute (one of the
major professional bodies representing those working in the securities and investment industry in the UK and, increasingly, internationally) agreed to support the research by forwarding an e-mail, with a web link to an electronic version of the questionnaire to sub-sets of their members. The UK Shareholders Association (UKSA) agreed to forward an e-mail to all their members with a known e-mail address and the Securities and Investment Institute (SII) agreed to do so to the members of their ‘Wealth Management Forum’ as well as to some other fund managers. Both the UKSA and the SII permitted one follow up e-mail to enhance response rates.

In addition to distributing the investor questionnaire through the UKSA and the SII, a list of names was provided by ICAS of members working in the investment analysis and investment management arenas and the City Wire and AIC (Association of Investment Companies) websites were used to provide more names. A list of 559 fund managers and analysts was compiled from these three sources and the questionnaire was distributed both by e-mail [n=122] and post [n=437]. One reminder was sent for those questionnaires sent electronically but in the case of those sent by post no reminder was sent because the natural time for issuing a reminder letter, mid-September 2008, coincided with the commencement of one of the most intense periods of the recent financial and economic crisis and with dramatic falls in equity prices worldwide. It was considered, therefore, that a questionnaire reminder would carry little impact for potential respondents and elicit little response.

The short questionnaire intended for non-investors was distributed by post. The objective of this shorter questionnaire was to elicit the views of a range of non-investor stakeholders on the issues covered by the research. While an attempt was made to survey as representative a selection of non-investors as possible, it was recognised that comprehensive coverage was impractical. In particular, no attempt was made to cover mainstream lenders as the research coincided with the
2008 financial crisis a meaningful response from this group seemed unlikely. This is acknowledged as a limitation of the research.

Several groups were targeted: business users of corporate reports, for example as suppliers of goods, services or credit; non-auditor practising accountants and politicians. Questionnaires were sent to social and environmental groups and to trade unions but achieved only negligible response rates. Instead, interviews were carried out with representatives of these groups. ICAS facilitated the identification of the largest group by providing an extensive listing of members in business from which a sample of 430 was selected representing financial managers, accountants and financial directors, representing a wide range of businesses and industries. To investigate the views of credit analysts, a sample of 50 Standard & Poors analysts was selected covering a range of different industries and geographies. The views of insolvency practitioners were also elicited as potential users of corporate narrative reporting; ICAS provided a listing of insolvency practitioners and these were all surveyed. Finally, in order to identify the views of politicians on the research issues, the non-investor questionnaire was sent to all 128 members of the Scottish parliament. No reminders were sent to recipients of the non-investor questionnaires as it was considered that the number of further responses would be insignificant.

Table 3.1 shows survey details for the investor questionnaire. ‘Finance professionals’ is a heterogeneous category which applies principally to the SII-generated responses. It composes individuals working in the finance and investment industry other than as fund managers or analysts such as pension fund managers, risk managers, company secretaries, corporate governance and compliance directors or managers.
Table 3.1  Number and distribution of responses: investor questionnaire

<table>
<thead>
<tr>
<th>Survey sources</th>
<th>Number Surveyed</th>
<th>Number responding</th>
<th>Response rate</th>
<th>Fund managers &amp; analysts</th>
<th>Finance professionals</th>
<th>Private shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>UKSA [e-mail]</td>
<td>550</td>
<td>87</td>
<td>15.8%</td>
<td>-</td>
<td>-</td>
<td>87</td>
</tr>
<tr>
<td>SII [e-mail]</td>
<td>600</td>
<td>64</td>
<td>10.7%</td>
<td>11</td>
<td>40</td>
<td>13</td>
</tr>
<tr>
<td>ICAS, City Wire, AIC [e-mail]</td>
<td>122</td>
<td>14</td>
<td>11.5%</td>
<td>9</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>ICAS [postal]</td>
<td>437</td>
<td>41</td>
<td>9.4%</td>
<td>37</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,709</strong></td>
<td><strong>206</strong></td>
<td><strong>12.1%</strong></td>
<td><strong>57</strong></td>
<td><strong>47</strong></td>
<td><strong>102</strong></td>
</tr>
</tbody>
</table>

The timing of the distribution of both postal and e-mail questionnaires coincided broadly with the first stage of the 2008 financial meltdown. Given this timing and the significant amount of technical material included within the investor questionnaire, the response rates shown in Table 3.1 are regarded as satisfactory. Table 3.2 shows survey details for the short non-investor questionnaire.
Table 3.2  Number and distribution of responses: stakeholder questionnaire

<table>
<thead>
<tr>
<th>Respondent group</th>
<th>Number surveyed</th>
<th>Number responding</th>
<th>Response rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business users of corporate reports</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ICAS members in business</td>
<td>424</td>
<td>38</td>
<td>9.0%</td>
</tr>
<tr>
<td>Credit analysts (Standard &amp; Poors)</td>
<td>50</td>
<td>5</td>
<td>10.0%</td>
</tr>
<tr>
<td>Total</td>
<td>479</td>
<td>43</td>
<td>9.0%</td>
</tr>
<tr>
<td>Accountants in practice</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insolvency practitioners</td>
<td>91</td>
<td>21</td>
<td>23.1%</td>
</tr>
<tr>
<td>Other stakeholders</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Members of Scottish Parliament</td>
<td>129</td>
<td>7</td>
<td>5.4%</td>
</tr>
<tr>
<td>Others</td>
<td>11</td>
<td>11</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>140</td>
<td>18</td>
<td>12.9%</td>
</tr>
<tr>
<td>Overall total</td>
<td>710</td>
<td>82</td>
<td>11.6%</td>
</tr>
</tbody>
</table>

These response rates are regarded as satisfactory, particularly for the core business groups.

Interviews

Twenty-six interviews were carried out with questionnaire respondents who had indicated a willingness to discuss the issues further. As far as possible, the individuals were selected so as to give a wide spread of interviews across the various respondent groups. Table 3.3 presents a summary of the interviewees.
**Table 3.3  Summary of interview participants**

<table>
<thead>
<tr>
<th>Panel A: Investors</th>
<th>Number of interviews</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participants</td>
<td></td>
</tr>
<tr>
<td>Fund managers [corporate governance specialists]</td>
<td>3</td>
</tr>
<tr>
<td>Fund managers [general]</td>
<td>7</td>
</tr>
<tr>
<td>Sell side analysts</td>
<td>3</td>
</tr>
<tr>
<td>Buy side analysts</td>
<td>2</td>
</tr>
<tr>
<td>Investment industry trade association representative</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>16</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel B: Non-investor stakeholders</th>
<th>Number of interviews</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participants</td>
<td></td>
</tr>
<tr>
<td>Private shareholders</td>
<td>4</td>
</tr>
<tr>
<td>Environmental agency</td>
<td>1</td>
</tr>
<tr>
<td>Community business organisation [2 interviewees]</td>
<td>1</td>
</tr>
<tr>
<td>Trade union representative [STUC]</td>
<td>1</td>
</tr>
<tr>
<td>Member of Scottish parliament</td>
<td>1</td>
</tr>
<tr>
<td>Business user of corporate reports</td>
<td>1</td>
</tr>
<tr>
<td>Insolvency practitioner</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>10</strong></td>
</tr>
</tbody>
</table>

The interviews were semi-structured around a broad interview agenda which was shown to the interviewees prior to the start of the interview. The duration of each interview was around one hour on average. All interviews were recorded; chapters four to six of the report include extracts from the interview transcripts where appropriate.
Analysis and discussion of results

The results of both questionnaire surveys and interviews are analysed and discussed in chapters four to six as follows:

- **Chapter 4** – The importance of management commentary including cognate issues such as views on the role of regulation and factors that inhibit management commentary usefulness.

- **Chapter 5** – The need for external assurance on management commentary and the depth, scope and form of the assurance that might be provided.

- **Chapter 6** – The robustness of the contemporary external audit process and the usefulness of current external audit reports. This chapter also discusses any other significant issues of concern highlighted by research participants.

**Questionnaire results**

The questionnaire results, aside from 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 3.4 shows the questionnaire respondents and the abbreviations used for the tables in chapters four to six which present the results of the two questionnaire surveys.
Table 3.4 Abbreviations used for questionnaire respondents in results tables

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Meaning</th>
<th>Number of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMA</td>
<td>Fund managers and analysts</td>
<td>57</td>
</tr>
<tr>
<td>FP</td>
<td>Other finance professionals</td>
<td>47</td>
</tr>
<tr>
<td>PS</td>
<td>Private shareholders</td>
<td>102</td>
</tr>
<tr>
<td>IP</td>
<td>Insolvency practitioners</td>
<td>21</td>
</tr>
<tr>
<td>AB</td>
<td>Business users of corporate reports</td>
<td>43</td>
</tr>
<tr>
<td>OS</td>
<td>Other stakeholders</td>
<td>18</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>288</strong></td>
<td></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 3.5 shows an approximate guide to the mean scores given in the tables.

Table 3.5 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 within the group. In general, a lower standard deviation for any particular mean score implies a higher level of consensus. The tables present both
means and standard deviations for each respondent group and for the total of all respondents. As a very broad guide the degree of dispersion as measured by the standard deviation may be characterised 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 encompass considerable variation in respondent views.

For each survey separately, Kruskal-Wallis tests were carried out to identify the existence of overall inter-group differences in the question responses; two post-hoc tests were then carried out to test for significant differences at a 5% significance level between the scores given by each respondent sub-group. The unnamed non-parametric test for follow-up multiple comparisons, as described by Siegel and Castellan (1988, p.213), was carried out and, also, as an additional check, a Mann-Whitney test, adjusted by a Bonferroni correction. While the results of the two post-hoc tests were largely identical with one another, the tables in chapters four to six report the results of the Siegel and Castellan test. Additionally, in the case of those questions which were identical, or substantively comparable, for both surveys, responses were compared for significant differences at 5% between the two main groups (investors and non-investors) using a Mann-Whitney test. All such differences are also reported in the tables.

**Interview results**

The interview extracts discussed in chapters four to six appear in italics. Table 3.6 shows the codes inserted at the end of each interview extract to identify the category of interviewee.
Table 3.6  Codes used to identify category of interviewee

<table>
<thead>
<tr>
<th>Code</th>
<th>Interviewee category</th>
</tr>
</thead>
<tbody>
<tr>
<td>FM</td>
<td>Fund manager</td>
</tr>
<tr>
<td>SSA</td>
<td>Sell side analyst</td>
</tr>
<tr>
<td>BSA</td>
<td>Buy side analyst</td>
</tr>
<tr>
<td>IR</td>
<td>Representative of investment industry trade association</td>
</tr>
<tr>
<td>PS</td>
<td>Private shareholder</td>
</tr>
<tr>
<td>EA</td>
<td>Environmental agency</td>
</tr>
<tr>
<td>CB</td>
<td>Community business organisation [2 interviewees]</td>
</tr>
<tr>
<td>TU</td>
<td>Trade union representative [STUC]</td>
</tr>
<tr>
<td>MSP</td>
<td>Member of Scottish parliament</td>
</tr>
<tr>
<td>BU</td>
<td>Business user of corporate reports</td>
</tr>
<tr>
<td>IP</td>
<td>Insolvency practitioner</td>
</tr>
</tbody>
</table>

All the interview recordings were transcribed. The interview transcriptions were then analysed using the NVIVO software package for analysing qualitative data. Initially, nodes were developed using the research questions for the study and the pre-interview agenda. As a consistency check, a manual tabular analysis of the interview transcripts, based upon the interview agenda, was also carried out.

The next chapter discusses stakeholder perceptions on management commentary.
4 MANAGEMENT COMMENTARY: STAKEHOLDER PERCEPTIONS

Introduction

This chapter investigates the perceptions of both investors and other stakeholders on a variety of issues on narrative reporting in general and on management commentary in particular. Both the investor and non-investor questionnaire surveys dealt with these issues. The main thrust of the relevant questions in both questionnaire surveys was to ascertain the importance of management commentary to financial report users and the perceived usefulness of the management commentary in the precise form proposed by the IASB discussion document.

Knowledge of corporate reporting and of management commentary

The extent of investors’ knowledge and use of corporate reporting, generally, and their familiarity with the IASB discussion paper (IASB, 2005) on management commentary was investigated. Questions asked respondents to rank their knowledge or familiarity, as appropriate, as shown in the first column of Table 4.1.
Table 4.1  Investor knowledge and use of corporate reporting and familiarity with IASB discussion paper

<table>
<thead>
<tr>
<th>Knowledge of corporate reporting</th>
<th>Total</th>
<th>FMA</th>
<th>FP</th>
<th>PS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expert user</td>
<td>49</td>
<td>29</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Good standard</td>
<td>80</td>
<td>20</td>
<td>20</td>
<td>40</td>
</tr>
<tr>
<td>Fair standard</td>
<td>59</td>
<td>7</td>
<td>12</td>
<td>40</td>
</tr>
<tr>
<td>Little or none</td>
<td>18</td>
<td>1</td>
<td>5</td>
<td>12</td>
</tr>
<tr>
<td>Total</td>
<td>206</td>
<td>57</td>
<td>47</td>
<td>102</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Knowledge of IASB discussion paper</th>
<th>Total</th>
<th>FMA</th>
<th>FP</th>
<th>PS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Detailed knowledge</td>
<td>2</td>
<td>1</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Good standard</td>
<td>13</td>
<td>9</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Fair standard</td>
<td>30</td>
<td>10</td>
<td>7</td>
<td>13</td>
</tr>
<tr>
<td>Little or none</td>
<td>136</td>
<td>35</td>
<td>27</td>
<td>74</td>
</tr>
<tr>
<td>Total</td>
<td>181</td>
<td>55</td>
<td>37</td>
<td>89</td>
</tr>
</tbody>
</table>

Note:
Figures shown in table are absolute numbers

As shown in Table 4.1, 129 respondents in total, or 63%, described themselves as being expert users or having a good knowledge of corporate reporting. Eighty six percent of fund managers and analysts claimed to fall into these two categories. At the other extreme, around 9% of both other finance professionals and private shareholders, claimed to have little or no knowledge of corporate reporting. In contrast to the knowledge of financial reporting claimed, few respondents across all three investor sub-categories claimed to have a detailed or good knowledge of the IASB discussion paper. Of the 181 respondents who expressed a view on their knowledge of the discussion paper, 136 indicated little or no knowledge. As far as the three sub-categories of investors are concerned, the percentage of private shareholders claiming little or no knowledge was highest at 83% but substantial majorities of the respondents for
both fund managers and analyst and private shareholder categories also fell into this category. Twenty five respondents chose not to answer this question at all so it is reasonable to infer that they also had little or no knowledge of the IASB paper. On this basis a total of 161 of all 206 respondents (78%) had little or no knowledge of the IASB paper. Table 4.2 presents a cross-tabulation between knowledge of corporate reporting and knowledge of the IASB paper.

**Table 4.2 Cross-tabulation of investors’ knowledge of corporate reporting and familiarity with the IASB discussion paper on management commentary**

<table>
<thead>
<tr>
<th>Knowledge of corporate reporting</th>
<th>Knowledge of IASB discussion paper</th>
<th>Total</th>
<th>FMA</th>
<th>FP</th>
<th>PS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expert user</td>
<td>Detailed</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Good standard</td>
<td>4</td>
<td>3</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair standard</td>
<td>10</td>
<td>6</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>Little or none</td>
<td>32</td>
<td>20</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Good standard</td>
<td>Detailed</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Good standard</td>
<td>9</td>
<td>6</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Fair standard</td>
<td>13</td>
<td>4</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>Little or none</td>
<td>49</td>
<td>9</td>
<td>11</td>
<td>29</td>
</tr>
<tr>
<td>Fair standard</td>
<td>Detailed</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Good standard</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair standard</td>
<td>6</td>
<td>1</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Little or none</td>
<td>42</td>
<td>6</td>
<td>7</td>
<td>29</td>
</tr>
<tr>
<td>Little or none</td>
<td>Detailed</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Good standard</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Fair standard</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Little or none</td>
<td>13</td>
<td>3</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>181</td>
<td>55</td>
<td>37</td>
<td>89</td>
</tr>
</tbody>
</table>

**Note:**
Figures shown in table are absolute numbers.
Table 4.2 suggests only a weak relationship between investors’ knowledge and of corporate reporting and their familiarity with the IASB discussion paper. This is perhaps unsurprising given that the discussion paper does not appear to have enjoyed an extensive degree of exposure within the UK business and financial communities.

**Perceived importance of narrative reporting and of management commentary**

While many investors may be unfamiliar with the IASB discussion paper on management commentary, Table 4.3 indicates that there is evidence of widespread agreement across all investor groups that narrative information will increasingly be a feature of future corporate reporting.

**Table 4.3 Narrative information in future corporate reporting**

<table>
<thead>
<tr>
<th>Investment agreement with the suggestion that future corporate reporting will increasingly incorporate information of a narrative character?¹</th>
<th>Total</th>
<th>FMA</th>
<th>FP</th>
<th>PS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
</tr>
<tr>
<td>Investor agreement with the suggestion that future corporate reporting will increasingly incorporate information of a narrative character?¹</td>
<td>2.33</td>
<td>0.76</td>
<td>2.38</td>
<td>0.75</td>
</tr>
</tbody>
</table>

Note: ¹ No significant differences at 5% between the mean scores for each of the three investor sub-categories.

Legend: 1 = Agree strongly  2 = Agree  3 = Neutral  4 = Disagree  5 = Disagree strongly

There are no significant differences, at 5%, between the views of the various investor groups on this issue and the standard deviations for the scores shown in Table 4.3 demonstrate a high level of general consensus. Around 65% of all respondents to this question agreed, or agreed strongly, with the suggestion and only around 5% indicated a negative opinion.
It was not considered appropriate to ask non-investors for their views as to the importance of the narrative element within future corporate reporting given their, assumed, relative lack of familiarity with the area. Non-investors, however, were asked about the usefulness of the narrative parts of company annual reports to them as stakeholders as shown in Table 4.4.

Table 4.4 Usefulness of narrative in company annual reports to non-investors

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>IP</th>
<th>AB</th>
<th>OS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
</tr>
<tr>
<td>Usefulness of narrative elements of company annual reports to non-investor stakeholders¹</td>
<td>2.41</td>
<td>0.93</td>
<td>2.48</td>
<td>0.87</td>
</tr>
</tbody>
</table>

Note:
¹ No significant differences at 5% between mean scores for each of the three stakeholder groups.

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

The narrative element within company annual reports is clearly important to all three non-investor groups. There are no significant differences at 5% between the three groups and, taking the respondents to this question as a whole, over 60% indicated that the narrative elements were ‘useful’ or ‘very useful’ with only 16% signalling that these parts of annual reports were ‘not very useful’ (or ‘useless’ in one individual case only).

A majority of interviewees over all respondent groups confirmed the increasing importance of the narrative element of corporate reports to users. There was a suggestion that what was really required was a more holistic approach to corporate reporting:
There is too much distinction between narrative reporting and accounting reporting and, as a consequence, we don’t do justice to either. (FM1)

The increasing complexity of accounting standards and measurement issues implies that it will be appropriate for the quantity of narrative to increase, as companies realise that fuller explanations are required to enable users, faced with complex quantitative data, to understand corporate performance. As one fund manager commented:

I think… that companies will feel increasingly a greater obligation to tell their own story and to get their messages across clearly. But there are aspects of fair value accounting and matters that never went through the P&L before, that do now and therefore require a great deal more explanation. And management must want to get back to telling more clearly their version of the performance of the underlying operation rather than having it clouded by a load of other stuff. And that therefore must make narrative more … important to their perception of the business that they want to explain to us as users. (FM2)

Fund managers and analysts hold mixed views on the importance of annual reports in general and narrative reporting in particular. Some saw certain elements of the narrative content of annual reports as enabling analysts to probe what was going on at a level below the financial numbers:

The two key performance metrics which analysts look at are the organic revenue growth and underlying margin progression. These are non-IFRS measures and we use those to calibrate a view of underlying, normalised, adjusted operating profit. (SSA1)
Management commentary, in particular, was also seen as adding value in facilitating an ongoing dialogue with directors on business prospects, the risks and challenges faced and exploring the benchmarks and milestones against which performance can be assessed. There was a perceived need to engage to a greater extent in the realism of the business dynamics and the risks involved in these dynamics:

So this is where the linkage between financial statements and the broader narrative… that are presented by a company become so important. (FM8)

One analyst explained that he tended to use the management commentary to obtain clues as to strategy and then compare what is written to what happens in practice:

I often use it to get an idea of the key performance indicators that management are looking at so as to question them on how they’re doing relative to performance. (BSA1)

Other analysts regarded the management commentary as being of less importance to them, stating that they rely more on current information such as daily movements in share prices, interim announcements by management and the conference calls and analysts’ meetings that accompany these announcements. In addition, a great deal of information is obtained from private briefing sessions with management. By the time the annual report arrives it is a very historic document and all the key information will already have been fed into the market. Sell-side analysts, in particular, have only extremely limited use for corporate report disclosures. One put it thus:
The only real use (of management commentary) for me is if I am starting initially with a new company and I am starting completely from scratch and I don't know very much about it, then the annual report gives me that information. (SSA3)

This particular analyst was an industry specialist who devoted his time to tracking and analysing a fairly small number of companies (around 20) within his sector. It is unsurprising, therefore, that he had relatively little use for a relatively general document produced annually. On the other hand, while emphasising his primary reliance upon internal research, another analyst explained that he tended to read management reports carefully in order to identify underlying trends in business development and changes in these trends:

This report forms the basis for financial analysis which in turn creates the basis for questions that we ask management in order to understand the business dynamics and see where it is going in the future. (BSA2)

The private shareholders interviewed, acknowledged the importance of the narrative elements within narrative reports, but had some reservations about their usefulness. In this they may not necessarily have been typical of the private shareholder respondents to the investor survey. One expressed his reservations about excessive length and management ‘spin’ irreverently:

Certainly there seems to be an awful lot of management verbiage in the ones I do remember reading, where even if you did nothing else you could edit the thing down to about a quarter of the actual length because they blather on meaninglessly a lot of the time and if somebody who was a Sunday Post sub-editor cut it all down to the absolute minimum then it would be a lot more readable and
people might actually read more of it because it wouldn’t take them an age to plough through all the guff. (PS1)

Other unfavourable private investor comments on these aspects of the narrative elements of corporate reporting included this extract:

It’s [i.e. the narrative element of corporate reports] growing, it’s sometimes useful, but I would regard most annual reports as a spruced up version of reality, whereas I would rather have reality but I’m a realist and I realise that if you’re in charge of something and you’ve got to look out for yourself from the outside world then you’re going to put the best gloss on it. (PS2)

There may be an important lesson to learn from these comments, although one unarticulated by the investors themselves. Some external assurance may be necessary in order to engender robust confidence in the management commentary, particularly for non-expert users.

Non-investor interviewees generally valued the narrative dimension of annual reports and were keen that this should be developed and become more transparent. The non-investors surveyed and interviewed constitute a very diverse group; even so, the management commentary appears to be useful to each group surveyed. The insolvency practitioner interviewed certainly found the management commentary to be a useful document.

I think the management commentary is a vital part and it’s probably the first thing I would read even before I would look at the numbers. Firstly, because it would tell me what the company does and this would influence my gut feel about the organisation… I think sometimes it tells you more by omission than what’s actually there but it’s also a sense of the language that they use to express how the company has performed. Secondly, I would focus very
heavily on the comments that they had used around their current performance... to try to set the context. (IP)

The representative of the trade union movement, while acknowledging that the union movement did not tend to use corporate reports as matter of course, indicated that an enhanced corporate reporting model would be welcomed:

_I think in contacting us your work has raised a number of issues about how we go about things here and perhaps suggests a few things that we should maybe be a bit more proactive on in terms of studying the company reports of Scotland’s biggest companies. I have to state, as a caveat at the start, we do not do this as a matter of course. I think having admitted that, it is probably a bit cheeky to talk about my perception of these things given I don’t read them! But my perception is that the quality of company reports is not particularly great in Scotland and doesn’t tell us those things about companies that we would like to know as workers and citizens. I think this is probably reflected in much that has happened in the economy over the last couple of years. We have to ask ourselves how some of our very major companies can go in a few months from a perceived position of major strength within their industrial sectors to positions whereby they are no longer credible institutions. How do they inform the wider community of what they are doing? My perception is that they cannot be doing this particularly effectively or, I hesitate to introduce a pejorative word, honestly. I think that this should be an issue for STUC moving forward... what can we do to assist companies in improving the quality of their reporting? (TU)_

The research did not systematically seek to identify the perceptions of union stakeholders on the issues. These comments of the union representative, however, may be indicative of a largely unarticulated
demand for accessible and usable corporate reporting. This interviewee went on to say that:

Workers who have an interest in what is going on in a particular company should be informed of what that company is doing, and what they are investing in, and I would imagine that narrative sections of the annual report have a role to play here. (TU)

The business CFO reiterated the importance of management commentary, while at the same time emphasising the prevalence of management ‘spin’:

I think management commentary is important if it is validly prepared and presented and adequately factual. I think too often there is a gloss put on things by management in their commentary that attempts to make things look rosier than perhaps they actually are. I think outlining the business risks will become much more of a focus than it has been. So, I think the management commentary will become much more important, but it will only be useful if it’s done seriously and with a real evaluation of the business risks and that’s where I am concerned… that it’s not going to do that. (BU)

In summary, the interviews reveal that stakeholder groups have different information needs but there is a general consensus that the narrative elements of corporate reports, and the management commentary in particular, are useful. The following two comments illustrate these points:

Anybody who says the annual report doesn’t matter is simply wrong… No-one who is a genuine investor, and who wants to be part of a company, thinks that the annual report is irrelevant. The annual report is a vital document. (FM2)
Accounts comprise numbers and a certain amount of narrative and investors really do value the management commentary. Not only does it paint a clearer picture as to what has happened in relation to the numbers reported (which is essentially looking at historical information) but it can also give an indication of the risks to the business, how it is progressing and potential future developments. What investors want is more colour, more company-specific information on what has happened and future prospects. (IR)

Perceived importance of management commentary in understanding corporate attributes

Both the investor and non-investor questionnaire surveys incorporated almost identical questions which aimed to elicit perceptions as to the importance of management commentary in enabling users to understand several key business elements and indicators. Each of these questions was structured around the specific elements of management commentary highlighted by the IASB discussion document (IASB, 2003). The results for these questions are presented in Table 4.5.

Table 4.5 The importance of management commentary in understanding various business dimensions

<table>
<thead>
<tr>
<th>Business dimensions</th>
<th>Total</th>
<th>FMA</th>
<th>FP</th>
<th>PS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
</tr>
<tr>
<td>Nature of business³</td>
<td>1.84</td>
<td>0.86</td>
<td>2.07</td>
<td>0.87</td>
</tr>
<tr>
<td>Objectives and strategies³</td>
<td>1.68</td>
<td>0.83</td>
<td>1.85</td>
<td>0.83</td>
</tr>
<tr>
<td>Key resources, risks and relationships¹</td>
<td>2.03</td>
<td>0.95</td>
<td>2.33</td>
<td>0.94</td>
</tr>
<tr>
<td>Past results¹,³</td>
<td>2.50</td>
<td>0.95</td>
<td>2.79</td>
<td>0.95</td>
</tr>
<tr>
<td>Future prospects¹</td>
<td>2.10</td>
<td>0.99</td>
<td>2.52</td>
<td>0.98</td>
</tr>
<tr>
<td>Performance measures and indicators¹</td>
<td>2.30</td>
<td>1.04</td>
<td>2.58</td>
<td>1.04</td>
</tr>
</tbody>
</table>
Table 4.5 The importance of management commentary in understanding various business dimensions (Cont.)

<table>
<thead>
<tr>
<th>Panel B: Non-investor stakeholders</th>
<th>Total M</th>
<th>SD</th>
<th>IP M</th>
<th>SD</th>
<th>AB M</th>
<th>SD</th>
<th>OS M</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nature of business*3</td>
<td>2.28</td>
<td>0.93</td>
<td>2.10</td>
<td>0.62</td>
<td>2.35</td>
<td>1.02</td>
<td>2.33</td>
<td>1.03</td>
</tr>
<tr>
<td>Objectives and strategies*3</td>
<td>2.11</td>
<td>0.82</td>
<td>2.19</td>
<td>0.81</td>
<td>2.21</td>
<td>0.89</td>
<td>1.78</td>
<td>0.55</td>
</tr>
<tr>
<td>Key resources, risks and relationships</td>
<td>2.21</td>
<td>0.96</td>
<td>2.48</td>
<td>1.03</td>
<td>2.16</td>
<td>0.95</td>
<td>2.00</td>
<td>0.87</td>
</tr>
<tr>
<td>Past results and future prospects*3</td>
<td>2.20</td>
<td>0.87</td>
<td>2.38</td>
<td>0.86</td>
<td>2.16</td>
<td>0.81</td>
<td>2.06</td>
<td>1.03</td>
</tr>
<tr>
<td>Performance measures and indicators*2</td>
<td>2.49</td>
<td>0.98</td>
<td>2.62</td>
<td>1.02</td>
<td>2.65</td>
<td>0.92</td>
<td>1.94</td>
<td>0.90</td>
</tr>
</tbody>
</table>

Notes:
1 Significant difference at 5% between mean scores for fund managers and analysts and those for private shareholders.
2 Significant difference at 5% between mean scores for other stakeholders and those for accountants in business.
3 Significant difference at 5% between mean scores for investors and those for non-investor stakeholders.

In general, the results presented in Table 4.5 suggest that all groups, both investors and non-investors, generally hold positive views about the importance of management commentary in providing information on several key organisational dimensions but investor views are slightly more positive; this reflects, in particular, the views of private shareholders who regarded management commentary as more significant than did any of the other five respondent sub-groups.

While there is some diversity of view among both investors and non-investors, almost no individuals from either group indicated that they regarded any of the corporate dimensions which formed the focus of the question as either ‘unimportant’ or ‘very unimportant’ although...
around 10% of investors regarded ‘performance measures and indicators’, ‘past results’ and, to a lesser extent, ‘future prospects’ as less important.

Within the investor groups, fund managers and analysts, with access to information not readily available to private shareholders, such as private briefings, conference calls and so on, do not appear to regard management commentary as their primary source of information on key corporate attributes. On all dimensions, they scored the management commentary as a less important information source than did private shareholders whose scoring of the question indicates that they attribute a very high degree of importance to management commentary. The importance attributed to management commentary by ‘other finance professionals’ is greater than for fund managers and for analysts but less than for private shareholders; this may reflect the differential access to privileged information sources of each investor sub-group.

Interviewees, specifically professional investors, emphasised the historic aspects of management commentary and its ability to shed light on the figures in the financial statements. Despite the seemingly straightforward nature of these aspects of management commentary, research participants emphasised the importance of robust content. One fund manager put it like this:

*The backward looking aspects of the commentary have to be consistent with whatever has been produced in the numbers. You cannot have a situation where the sales of the company have fallen by 10% and yet the chief executive is talking about ‘how wonderful we were expanding the business’ and things like that. You’ve got to make sure the words actually match up with the numbers.* (FM5)

The following comment by an analyst brings out his view that even the more straightforward aspects of management commentary tended to be characterised by ‘spin’:
It's very clear that wherever you look in the financial statements all the highlighted numbers are chosen to show the results in the best possible way. (SSA2)

As far as the future dimensions of management commentary are concerned, although professional investors studied the forecasts made by directors, there was recognition that these might be somewhat nebulous and therefore that it was appropriate to regard these with a degree of doubt:

I don't see it (i.e. management commentary) as looking to the future to be honest. It is a very consciously retrospective statement. (SSA1)

I suspect the area which gives them greater headaches is the extent to which they can be pushed to talk more about the future, in particular the extent to which anything they say could be held against them at a future date and management are very nervous about making anything that could be close to a forecast. (FM5)

Concern about confidentiality was thought also to constrain the extent of future information:

I don't think you could expect any company to put actual numbers on their outlook statement at all. For competitive reasons, perhaps internal reasons as well if you've got different divisions competing against one another, I don't see that they could actually give you concrete forecasts in those outlook statements. (FM4)

Some analysts, however, believed that they could interpret the opaque language used by directors to infer information about the company’s future. For example:
I always look for forward-looking statements but I have a feeling that management are very conscious of the risk of making forward-looking statements and therefore they tend to be rather bland in what they say. However, I’m aware that certain phrases have deeper meanings than perhaps the analyst community learns of. Something like ‘difficult to have visibility’ is a key phrase for ‘haven’t got a clue’ and so on. (BSA1)

One fund manager, representing a very large fund management group, emphasised the relative importance of the future-orientated components of management commentary despite recognising the inherent difficulties.

That for us is probably the most useful piece of the management commentary... and it is the bit that, for the directors, is always the hardest to write because they feel that they are sticking their necks out. (FM2)

Interviewees highlighted some specific elements of management commentary other than the simple distinction between the past/present and future dimensions. ‘Risk’ was probably the most obvious example of this. A serious discussion of the future risks faced by companies was considered to be an important aspect of management commentary and one that was often lacking in annual reports While risk disclosure was seen as useful for users, the view was also expressed that one of the benefits of narrative reporting for management was that it had the potential for improving the focus on risks. A major aspect of the present financial crisis was the lack of appreciation of the problems faced. If attempts were made to crystallise the company’s views on risk, the opportunity would be created for a debate that might cast light on the level of risk exposure. The exercise of explaining the risk exposure in the narrative commentary might act as a catalyst for a greater appreciation of the
issues within the organisation. Comments on risk were made by both investors and non-investors. Those by fund managers included:

*Some indication of the various risks involved would be helpful. For me the value of narrative reporting to management is that it improves the focus on risks.* (FM3)

Another fund manager suggested that it was important that management commentary content was not inhibited by ‘boilerplate’ or by undue attention to legal concerns:

*What we want from this (risk) reporting is probably exactly the opposite of the ‘lawyered’ version that I was talking about. What are the five key risks that the company sees itself facing over the next year or so and how those risks are being managed? Possibly also including one more, something else that is coming up, rising up the agenda, and how that is being overseen… So this would be much more specific, and much more into the nitty-gritty of the company itself rather than the very generic stuff that you sometimes see.* (FM2)

Non-investor stakeholders were also interested in reporting on risks. The following comment was made by the insolvency practitioner who was interviewed:

*[The problem] was really about people not fully understanding the extent of the commitments and therefore the risks that they were exposing their companies to. I’m not sure it would have changed behaviours but for me it would have been much more a line in the sand where a good non-exec could exert a level of challenge that where there is such a degree of complexity that if you can’t
explain it to somebody there is something that is not quite right. So I think for me the whole risk issue is probably going to come into very sharp focus and I think it is incredibly important if companies are willing to put in the effort to get it right. (IP)

The business accountant also emphasised the potentially very useful role that management commentary might play in communicating information on business risks:

*I know there is some focus on that [business risks] already, but I think there will be even more and I think that particularly in the current economic climate and looking back over the last few months, if you'd gone back six months to a year and looked at some of the published financial statements of businesses such as the Royal Bank of Scotland or Halifax Bank of Scotland, they would all have been saying wonderful things about how well they were doing and giving very little indication to the reader or user of those financial statements that there were any particular or major risks to those businesses. Now if we look at the last couple of months, it's a very different state of affairs.* (BU)

Social and environmental reporting issues did not form a major focus of the present research and the questionnaire surveys did not explore these issues. Nevertheless, some research participants were interested in comments on this area within the context of the management commentary. Such comment (possibly surprisingly) was not restricted to non-investors and one or two of the fund managers interviewed were sufficiently interested in the area to comment perceptively. One fund manager, representing an organisation with a significant public interest dimension, commented:
We aren’t a crusading environmental organisation but we are mindful of the longer term. We have liabilities for 50-60 years and climate change is going to kick in quite significantly in the later stages of our liability profile. What we haven’t cracked is how to match that with the shorter term horizons that investment managers have. I am involved with a climate change adaptation project, with three other investment houses, so we are pleased to see that most businesses, big businesses, pay attention to mitigation and carbon emission targets and reductions… And that, incidentally, can be measured. Quite how we get this into the management commentary is another matter. For me, it is another guise of risk. Business has to adapt to commercial opportunities and threats. Climate change is becoming increasingly a part of it whether we like it or not. (FM3)

These are interesting comments demonstrating the importance of environmental issues (for ‘business’, and arguably also, for more altruistic reasons) to a major fund management juxtaposed with perhaps a degree of uncertainly as to the precise method of reporting these most appropriately. Another fund manager, while also interested in environmental issues in the context of management commentary, was more interested in these issues in terms of what it said about the organisation and about management:

I am not sure that some of the environmental stuff is particularly useful. Carbon emission is an auditable number but… I think the commentary is more useful than the number itself. Why have they done that? What is that for? They are doing that to generate profit in the future. And that is a good thing. (FM9)

These comments indicate that for a variety of reasons investors may have an interest in potential management commentary subject matters
of apparently less direct relevance to them and that it may not always be appropriate for management commentary assurance to concentrate only on those aspects which are directly ‘measurable’.

One component of management commentary for which direct measurement is more important is key performance indicators (KPIs). The questionnaire responses do not suggest that this is an area on which either investors, or non-investors, place particular emphasis but a few investors commented on these, indicating their perceived importance:

*I often use management commentary to get an idea of the key performance indicators that management are looking at so as to question them on how they are doing.* (BSA1)

Additionally, one fund manager noted how this, apparently, ‘hard’ area of the management commentary could, like ‘softer’ areas, be subject to management ‘spin’:

*One of the bugbears, and where people get slightly twitchy, is with some of the slightly selective use of pro-forma information to support the spin... some of it is perfectly valid and some of it is used slightly tongue in cheek and that is an area where there does need to be some thinking in relation to how you tie these different bits together and how substantive some of the disclosures are. To give you an example, I was looking at a company this morning talking about the way it was going to measure its performance based on return on capital employed. This is a company that did an extremely expansive acquisition about 18 months ago and is looking into excluding tangibles from its capital employed. So, you sit there and you can immediately see we’re going to get a disconnect between the asserted performance in one part of the accounts and in the narrative compared to what we’re actually seeing in the fundamentals, which will be in our view very likely that they’ve*
not created value – it’s been a value destructive acquisition. So, it’s those kinds of things that need to be picked up – and that’s the difficulty. If we can deal with the principle that will be great but it’s how the devil is in the detail and how those elements that do link back to the numbers are actually justified. (FM8)

These comments reflect a view that placing reliance upon even the relatively straightforward elements of management commentary may be difficult without a robust assurance process and, indeed, another fund manager specifically pinpointed KPIs as one area where assurance might be most useful.

In summary, the past/present and the future dimensions of management commentary are useful in terms of understanding key corporate attributes. At a more specific level, there is interest in disclosures on risks, on social and environmental issues and on KPIs but there are potential problems arising from corporate manipulation or distortion. This has clear implications for the provision of assurance on management commentary as discussed in chapter five of this report.

**Barriers to management commentary usefulness**

This section explores investor perceptions as to factors which may inhibit the usefulness or scope of management commentary. The results from the questionnaire are presented in Table 4.6.
Table 4.6  Perceived importance by investors of various factors in restricting the scope of management commentary

<table>
<thead>
<tr>
<th>Factors</th>
<th>Total</th>
<th></th>
<th>FMA</th>
<th></th>
<th>FP</th>
<th></th>
<th>PS</th>
<th></th>
</tr>
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<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
</tr>
<tr>
<td>Use of ‘boilerplate’ language</td>
<td>2.26</td>
<td>0.95</td>
<td>2.36</td>
<td>0.96</td>
<td>2.17</td>
<td>0.85</td>
<td>2.23</td>
<td>0.98</td>
</tr>
<tr>
<td>Disclosing information to competitors</td>
<td>2.60</td>
<td>0.99</td>
<td>2.63</td>
<td>1.00</td>
<td>2.42</td>
<td>0.87</td>
<td>2.65</td>
<td>0.98</td>
</tr>
<tr>
<td>Being held accountable for unrealised predictions</td>
<td>2.37</td>
<td>1.11</td>
<td>2.55</td>
<td>1.12</td>
<td>2.12</td>
<td>0.91</td>
<td>2.36</td>
<td>1.18</td>
</tr>
<tr>
<td>Excessive length of narrative disclosures²</td>
<td>2.48</td>
<td>1.04</td>
<td>2.87</td>
<td>1.04</td>
<td>2.41</td>
<td>1.10</td>
<td>2.26</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Notes:

¹ Significant difference at 5% between mean scores for fund managers and analysts and those for private shareholders.

² Significant difference at 5% between mean scores for other finance professionals and those for private shareholders.

Legend: 1 = Very important  2 = Important  3 = Neutral  4 = Unimportant  5 = Very unimportant

All four factors highlighted in Table 4.6 have a detrimental effect on the scope and quality of management commentary with a significant degree of consensus between stakeholder groups. Each factor was indicated by around 50% or more of respondents to be an ‘important’ or ‘very important’ limitation. In general, the principal barriers to management commentary usefulness are perceived to be the use of boilerplate language and the danger of being held accountable for unrealised predictions. Some distinction can be drawn between the relative views of the three investor groups; fund managers and analysts perceive the excessive length of narrative disclosures as less of a problem than the other groups. This is plausible given the reasonable presumption that fund managers may have comparatively greater technical knowledge as well as considerably greater available time for analysis.
Interviewees expanded on the issues arising from the questionnaires and also highlighted other concerns. The principal complaint was managerial bullishness of the statements made and the amount of ‘spin’. Even those who emphasised the importance of management commentary believed that the language was too positive at times. The following interview extract is interesting in that it is that of a CFO in a sizable corporate organisation, thus incorporating a degree of self-appraisal:

*I think too often there is a gloss put on things by management in their commentary that attempts to make things look rosier than perhaps they actually are. So you sometimes have to read between the lines to get the full impact of what is really being said.* (BU)

There was recognition that it was inevitable for companies to seek to present themselves favourably and narratives required to be interpreted with scepticism. One fund manager, who dealt with smaller companies, made the following comment bringing out his preference for dealing with unquoted companies because of the comparative ease of access to reliable information:

*Do I trust management commentaries? Not hugely, they are bound to have layers of spin; there is a slant to them. There are very few times when the chairman is particularly honest; particularly just now, when the trend is going to be awful – you don’t see many sets of accounts saying that. They put a bit of a spin on for many reasons; they don’t want to give their competitors fire power. You don’t want to put off your customers. That is one of the problems of investing in listed companies which you don’t get with unquoted companies because with these you can actually get access to private information.* (FM6)
Given this sentiment, it was regarded as particularly important that there was consistency between the commentary and the numbers. One fund manager commented:

> In many cases management commentary is used by management to get across particular messages that they want shareholders to hear, either about strategy or an acquisition or a policy they have in place and very often it’s only when you get down to the numbers that you can actually find out whether the commentary ties in accurately with the numbers. (FM4)

Several investors expressed frustration at the unhelpful communication which resulted from ‘boilerplate’ and bland language:

> A lot of the written element of the report and accounts can be a bit business school and wishy-washy and motherhood and apple pie. (FM9)

It was suggested that audit firms contributed to the blandness of the documents:

> Most initiatives like this that start off with good intentions; by the time we’re 2-3 years into it we look at what others are doing and we end up with a lot of similarity in approach and a tendency that brings things down to the lowest common denominator. We end up with very specific uses of words and very carefully circumscribed language... the non-execs tend to circulate something that is largely prepared as boilerplate by the auditors and the board either says ‘yes’ or ‘no’ to it. (FM7)
A number of reasons were suggested for the prevalence of boilerplate. Management did not wish to disclose more information than their competitors and did not wish to commit to predictions which did not materialise. The possibility of ‘safe harbours’ for directors and auditors was raised by several interviewees in relation to future information but there was recognition that, once again, a balance needed struck to protect users from unrealistic assertions by directors:

*I think it is quite right that there should be safe harbours otherwise people will clam up. On the other hand, we have to have protection against reckless statements. I accept that you cannot have the certainty over future performance that you can have over past results. But with adequate safe harbours I think there can be meaningful comments and assurance on future prospects.* (FM3)

One fund manager suggested that one help to meaningful reporting was for the chairman to write the commentary personally.

*If you take narrative reporting in its broadest dimension the chairman’s statements which are worth reading are the ones that use the word “I” when writing them.* (FM1)

This fund manager believed that audit committees, as part of the interface between boards and shareholders, have a role in ensuring useful company-specific information is disclosed in corporate reports and that there is consistency between the financials and the management commentary:

*Perhaps audit committees are an under-utilised part of the reporting process. I think that they could provide a useful role and be more expansive and effective in reporting.* (FM1)
In summary, the interviewees reinforced the questionnaire results on barriers to management commentary usefulness; two concerns stand out: boilerplate language and perhaps the more insidiously malevolent problem of management ‘spin’.

The structure of management commentary

These issues have implications for the regulatory approach adopted. This issue was not addressed in the questionnaires but the opportunity was taken to explore perceptions on the need for a mandatory standard on management commentary, and on other cognate issues, in the interviews.

All interviewee groups generally welcomed the IASB’s involvement in setting at least a minimal benchmark for management commentary, but there was concern that too detailed and prescriptive an approach would be counter-productive and would lead to box-ticking. As one fund manager observed:

*Regulation would be a fairly blunt instrument given the multitude of industries that exist and if you go down that route you end up creating a boilerplate form of narrative disclosure that would immediately start falling into the trap of becoming bland.* (FM8)

Most interviewees supported light touch regulation to give directors a free hand in ‘telling the story’ of the company, its performance, its future prospects and its business risks. However, a balance needed to be struck between total laissez-faire and a rigid list of points to be covered:

*You’ve got two dangers at each end of the spectrum: over-regulation and boilerplate or complete freedom to spin corporately.* (FM8)

Some investors expressed unease at the prospect of yet more detailed regulation that might create a massive compliance process and which
would not add value; perhaps not even corresponding to the operating realities of individual companies:

*My fear is that it would become a very prescriptive framework. It would have to be universally applied and if it ended up being not quite what we wanted then it doesn’t fit anybody.* (SSA1)

On the other hand, too much leeway might encourage reporting companies to be selective, discussing only positive developments and hiding problems. This would not provide helpful information and would make comparison between companies difficult. Most interviewees believed that the way forward was to focus on the essentials and on a principles-based approach:

*I think perhaps there need to be clear principles and guidance that is purposive in terms of what is intended and what information should be covered.* (FM8)

With such a framework, disclosure quality might improve as companies got to grips with a new transparency culture. It was regarded as important for companies’ reporting to evolve in a mutually consistent fashion. The CFO interviewed, emphasised that a minimal regulatory framework was required:

*If one business does it reasonably and accurately they may be at a disadvantage to others who don’t and therefore I believe it becomes incumbent upon the regulatory authorities... that some impetus is achieved on what changes there need to be and how these changes should be reflected.* (BU)
For this to happen, the IASB need to mandate a broad framework for the overall purpose and content of management commentary supplemented by examples of good practice as guidance. There was also an onus on shareholders and skilled users to point out where companies were falling short. An analyst expressed his hopes for management commentary as follows:

*I’d like to see a framework within which management can act… some guiding principles, some outlines of the key things that might be expected but a little bit of freedom for firms to disclose what they want.* (BSA1)

Analysts and fund managers believed that such arrangements would allow them to identify points made and areas where directors were silent and use these as a basis for further discussion. However, one inhibitor of openness by directors was perceived to be a fear of potential litigation:

*We believe that management should have as free a hand as possible. That means not having the lawyers involved, so you need to have restrictions on the liability of directors for what they have written.* (FM2)

This investor’s view reflected that of his institution and is at one end of the spectrum of opinion on alternative regulatory approaches. Another fund manager stressed that a mandatory standard would restrict the private companies that constituted his arena of interest. The investment management industry representative had rather a different perspective, believing that a standard was required:

*We benchmarked with the IASB to do this and we did have concerns that it had dropped down its agenda and I know certain investors, not ourselves specifically, did write to the International*
Accounting Standards Board and ask it to put more emphasis on this in its agenda. We want colour and we want company specific information but also there needs to be an element of comparability and standard style; otherwise you have the potential for cherry picking. So, we need good high quality standards to develop the system internationally, but that said we don’t want boilerplate. (IR)

Thus, while there is a variety of opinion, among the broad ‘business’ constituency who participated in the research the most prevalent preference is for ‘light touch’ regulation.

As far as the minority of non-investor, and specifically ‘non-business’, interviewees was concerned, a more robust regulatory approach tended to be preferred. The representatives of the social and environmental organisations were interested in regulation that would require companies to disclose CSR information consistently:

One of the problems of reporting [on CSR] is that you can choose what you report on. So you end up showing what is good and hiding everything else… a framework where you are forced to disclose certain information would be great because that makes for more of a benchmark to measure different organisations with. (CB)

The union representative favoured imposing a common framework which would encourage better corporate practice and enable unions to, in his view, engage usefully with corporate activity:

My initial bias is towards a framework. The last decade has shown that there is quite a lot of bad practice and I think that rigorous frameworks are one way that we can help prevent this... common frameworks are helpful in that I think that certainly unions would be looking at these as a positive way of engaging with companies. (TU)
Summary

The findings in this chapter may be summarised as follows:

• Only a minority of investor group respondents across the three investor groups claimed a good knowledge of the IASB discussion document on management commentary.

• Investors and non-investors generally agreed that the future of corporate reporting would increasingly incorporate information of a narrative character and/or that the narrative sections of corporate reports were important to them.

• Users envisaged management commentary being used as part of a holistic approach to reporting, for clarifying aspects of increasingly opaque financial statements and as an entry point for more detailed corporate analysis.

• Investors and non-investors indicated that management commentary was of importance in understanding key resources, risks and relationships, past results, future prospects and performance measures and indicators but argued that information on many of these attributes was vulnerable to management ‘spin’ and distortion. Private shareholders placed more emphasis on management commentary than any other respondent group but fund managers and, in particular, analysts placed slightly less emphasis on management commentary possibly reflecting the greater variety of information sources at their disposal.

• Several factors limit the scope and usefulness of management commentary. Most important in this regard were the use of ‘boilerplate language’ and the misleading nature of management ‘spin’ suggesting the need for a reasonably robust assurance process if there is to be user confidence in management commentary reporting.

• The consensus of opinion amongst investors favours a light touch approach but non-investors favour one that is more robust.
5 Enhancing Management Commentary Usefulness: Assurance

Introduction

This chapter deals with the demand for assurance on management commentary which was a central concern of both the investor and non-investor questionnaires.

Assurance on management commentary

A primary question which sought to identify stakeholder views on the need for assurance on management commentary was included in both versions of the questionnaire. Respondents were required to score the importance of external assurance on the management commentary overall as well as on various ‘content elements’ which might reasonably be expected to be included within the commentary. The content elements chosen for inclusion in the question were based on the IASB exposure draft (IASB, 2009, paras.24-39).
### Table 5.1 Importance of an independent external audit on management commentary

#### Panel A: Investors

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<td>2.50</td>
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</tr>
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<td></td>
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<td>3.55</td>
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<tr>
<td></td>
<td>2.78</td>
<td>1.18</td>
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<tr>
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<td>indicators</td>
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#### Panel B: Non-investor stakeholders

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<td>1.06</td>
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<tr>
<td>indicators</td>
<td>2.70</td>
<td>1.04</td>
<td>1.94</td>
<td>0.87</td>
</tr>
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</table>

Notes:

1. Significant difference at 5% between mean scores for fund managers and analysts and those for private shareholders.
2. Significant difference at 5% between mean scores for fund managers and analysts and those for other finance professionals.
3. Significant difference at 5% between mean scores for accountants in business and those for other stakeholders.
4. Significant difference at 5% between mean scores for investors and those for non-investor stakeholders.

Legend: 1 = Agree strongly   2 = Agree   3 = Neutral   4 = Disagree   5 = Disagree strongly
At the most general level, the results suggest that it is important to provide assurance on the overall management commentary. The investor groups taken together scored this question at 2.56 and the non-investor groups at 2.18. Fifty six percent of responding investors indicated that the assurance of an external audit on management commentary was ‘very important’ or ‘important’ while 70% of those responding from the ‘non-investor’ groups did so. Even this basic question, however, prompted quite a small but still significant proportion of contrary views with 20% of responding investors and 15% of non-investors suggesting that an external audit of management commentary would be ‘not very useful’ or would even be ‘useless’.

As far as the perceived importance of assurance on the individual content elements of management commentary is concerned, the same pattern is evident with relatively high importance being placed, perhaps predictably, on past results and on performance measures and indicators. Non-investor responses were very positive as far as the audit of past results and future prospects, taken together, were concerned. Perhaps rather less predictably, assurance on ‘key resources, risks and relationships’, was also regarded positively by both investor and non-investors with 59% of investors and 65% of non-investors responding regarding this as ‘very important’ or ‘important’. Unsurprisingly, the ‘nature of the business’ and ‘objectives and strategies’ were scored by both investors and non-investors as the two content elements of management commentary that it would be least important for auditors to concentrate upon.

There are some apparent sub-group differences in the case of both investors and non-investors. Most obviously, within the investor groups, fund managers and analysts rated the importance of external assurance on management commentary as a whole, and on each content element of management commentary, as significantly less important (at the 5% level) than either of the other two investor ‘sub-groups’. Thus, the general attitude of the fund manager and analyst constituency was only ‘neutral’ towards external audit assurance on management commentary. There
is, however, a significant diversity of view, as indicated by the standard deviations. Fund managers and analysts are at least mildly positive on the prospect of external audit of ‘past results’ and ‘performance measures and indicators’ but ‘neutral’ on ‘key risks, resources and relationships’.

Fund managers and, even more so perhaps, analysts are accustomed to carrying out detailed research on areas such as future projections and risk analysis; they may see auditor involvement in these areas as something akin to an analyst role. Further, because of their background in this type of work, they may be more likely than other users to be aware of the limitations inherent in any attempt to ‘verify’ information of this nature. Finally, as discussed in the following chapter of this report, fund managers and analysts appear to be the least positive group as to the importance or desirability of management commentary assurance; this may reflect their views on external audit generally.

There was a wide variety of interviewee opinion on the desirability of providing external assurance on management commentary. Despite the potential obstacles or drawbacks highlighted by some investors, however, most interviewees believed assurance was at least theoretically desirable. As one fund manager said:

_In a perfect world, if you knew the management commentary was being assessed that would be helpful._ (FM6)

The interviews showed that investors were less in favour of assurance on management commentary than were non-investors. However, some professional investors who favoured management commentary assurance expressed their views robustly and enthusiastically. One of the principal reasons for this was a belief that assurance would add credibility to management commentary by moderating misleading information and over-optimistic statements by directors. One senior fund manager expressed his basic rationale for assurance on management commentary as follows:
I think there has to be some independent review of what actually is going into the financial statements in written form. I think the auditors are the most appropriate people to undertake that review because you cannot have a situation whereby you have a set of numbers being produced, which have been subject to audit and then you could have a completely separate commentary, which is not subject to review or is not being examined in context or for consistency in terms of what it is referring to. If management commentaries are not subject to review, management could put in whatever they like. (FM5)

This fund manager also linked this with the desirability of having assurance on management commentary performed by the external auditors. The alternative was stark:

The alternative is to just have companies produce the numbers—financial statements, the income statement balance sheet, the appropriate notes, a director’s report, and have no commentary. I am not sure that it is going to be particularly helpful for those who are not financially literate in order to interpret or assess how a company has performed or what its prospects may be. Having said that, at present, the commentaries that are included in financial statements... tend to be backward looking rather than forward-looking. I suspect there will probably be more pressure brought to bear for an increasing proportion of these comments to be forward-looking. (FM5)

This is an interesting view (although probably not one that would have been shared by most research participants) in that it suggests that management commentary and the associated assurance stand or fall together as a package; by implication the providers of assurance would require to engage with the prospective components of management...
commentary in order to execute their remit. Despite these potential difficulties and the challenges to auditors arising from operating in areas other than the familiar financial statement arena, another fund manager, a corporate governance specialist, reiterated the desirability of assurance being provided by the audit profession:

*I think there is a strong case in principle for assurance provided by external auditors. It would be a natural progression; the firms have the expertise and they have the capacity to develop into new areas. That is not to say there won’t be specialist types of assurance for environmental and other specialist kinds of data. I am very much in favour of the external auditor being involved.* (FM3)

This was overwhelmingly the consensus view; however suggestions were made by two interviewees to the effect that another audit firm should be involved in providing assurance on the narrative content of corporate reports. One fund manager argued:

*If you’ve got an auditor doing the actual numbers could you have a separate auditor brought in to look at the narrative and check that it links with the numbers? In most narratives no company is going to be able to resist the opportunity to give out a message about their business, whatever it might be. An independent audit of the narrative could say ‘No, that’s not acceptable because actually the trend in your sales figures is not up, it’s down so you can’t say your sales are improving in the narrative’.* (FM4)

This fund manager partly rationalised her suggestion on the grounds that it might help, albeit modestly, to restore confidence to troubled equity markets:
We've come through a year of the most dreadful conditions of equity and markets and it will put an entire generation off investing any money into shares again, sadly. The only way you will encourage people back in is if you restore confidence... this might be a way to increase shareholder’s confidence in the accounts. (FM4)

The idea was echoed in the more radical suggestion by a financial journalist who argued that, because of the closeness of auditors to client management, a separate independent ‘validator’ should be brought in on behalf of the shareholders to review the corporate reports (including the narrative components), identify weaknesses or inconsistencies in the message given and carry out such verification work as (s)he considered necessary.

I think that the validator’s duty would be to look at the total annual report cover to cover. He might say ‘the numbers in the annual report give any sensible person this impression and the first twenty pages of the annual report give this totally different impression and it’s the difference between the two that we are going to focus on’. (PS2)

These are interesting suggestions, not least because they are made when investors, corporations and regulators alike may be more receptive to more radical audit and governance solutions than at any time in recent economic history. While such approaches may be prohibitive economically, the frustrations expressed at apparent inconsistencies and the suggestion that the rhetoric of narrative disclosure is often unsupported by the supporting numbers, indicate some demand from the investing community for more independent assurance on all corporate report information. Another senior fund manager believed that assurance was required on management commentary and stated this firmly:
My own view of the future is one where the financial statements will be audited, the narrative reports will have a degree of assurance and will come under the totality of a report from the accountants on the corporate report, so that in effect you could have a two stage report – in our opinion the financial statements provide a true and fair view, we have reviewed the management commentary and in all material respects we have found it to be a fair reflection of the company’s circumstances. (FM1)

In response to the suggestion that this would be quite strong assurance this fund manager responded:

*I don't see it as strong assurance. I see it as appropriate assurance.*

(FM1)

These and similar sentiments expressed by other interviewees are at the positive end of the spectrum of views expressed by professional investors. Appropriately, it was left to the individual representing the professional body for the fund management industry to articulate the diversity of view existing amongst professionals:

*Our members’ views are quite mixed as to whether or not management commentary itself should be subject to verification. Some feel that to do so would potentially drive down the quality and produce much more rigid, boilerplate reporting and detract from the flexibility that the current climate affords it. Others think that it would actually enhance its credibility, if there were to be more review of the information reported.* (IR)

The suggestion that assurance on management commentary would result in more boilerplate or a very limited disclosure of hard facts was
echoed by several fund managers and analysts. The clear view expressed in the following two interview quotes is that assurance would affect the fine nuances of management commentary detrimentally:

The problem might be a move to factual information, which doesn't give any idea of the culture of the company, and sometimes you can get an idea of that just by going through the commentary. (FM4)

Having it checked for consistency with the accounts is fine but having it audited in itself would cause us some concern, because that then restricts the openness of the communication from management. They would feel obliged to show the auditors and justify to the lawyers that they can get away with saying it, rather than exposing themselves to risk. We fear that if there is too much oversight, it actually stops being an informative document. (FM2)

This last comment by a fund manager from a very large institution is representative of more ‘negative’ investor views; even this fund manager, however, makes clear that he is in favour of at least some minimum ‘consistency’ review. On the other hand some of those investors who favoured more robust approaches argued that it was appropriate that directors should think carefully about what they said:

Would having the commentary audited inhibit directors? I would be tempted to throw that back and say ‘Well, why are you saying things there that you’re not comfortable with and cannot be substantiated or would not stand up to scrutiny?’ (FM5)

There was a widespread view that directors make extremely positive statements that may be hard to substantiate and that some kind of independent scrutiny was needed to keep a rein on excessive optimism. One private shareholder expressed his frustration at this:
Perhaps [auditors] ought to be editing the content before it’s put down and saying ‘Well you can’t say that...’ I don’t know who writes annual reports but some of the ones I’ve seen do seem to be absolutely over the top in the way of verbiage and pages and pages of pretty pictures about supposed social responsibility. (PS1)

This private shareholder went on to suggest that such moderation of director statements might take place ‘behind the scenes’ as part of the audit rather than as part of the reporting process; in other words, auditors should have a greater input to the drafting of management commentary in the first place:

Maybe auditors should be asked to cast their eye over it in advance and say ‘Look, that doesn’t strike us as a very good idea, don’t you think you should rethink it?’ But they [i.e. the auditors] wouldn’t tell them what to put instead. (PS1)

In that situation auditors would only comment in the corporate reports if directors declined to moderate the comments made. A contrasting perspective, however, was articulated by a fund manager, from a smaller institution and with a recognised media profile, who believed that auditors were already too involved in the ‘drafting’ process and that this was one reason for much ‘boilerplate’:

With every report such as risk commentary, a pro forma comes round from the auditors about what’s normal [to say] and if non-executives question the pro-forma they’re told by the auditors what is normal and what is not. So it quickly settles into a common denominator of normality and what auditors say other people are doing. It is difficult to say much that is distinctive. (FM7)
Another fund manager, and corporate governance specialist, had similar concerns:

*I think there is a danger that we create these frameworks that are very lucrative but aren’t necessarily adding very much...What does the assurance add? Does it really add value and justify the cost? My answer is no.* (FM8)

Further discussions with this fund manager, however, revealed that part of his concern reflected wider reservations about current auditing (and, indeed, accounting) practice and the way in which this had become over ‘formulaic’. He did believe that there could be interest in management commentary assurance if these almost systemic problems were dealt with. Ideally the starting point would be:

…*giving the true and fair view... and all the usual words that everyone fights over what they mean and then tries to constrain by tying them to compliance with the basic technical standards.* (FM8)

So some reservations about the value of management commentary assurance appear to partially reflect perceptions about deficiencies in the existing audit model. Some of the professional investors who expressed less enthusiasm for external assurance on management commentary indicated that much of this was grounded in them personally having access to other superior information sources. Such investors, with access to evidence against which director statements in the management commentary could be ‘triangulated’, and who were experienced in ‘reading between the lines’ of corporate reports, were less convinced about how helpful audit assurance would be to them. However, they recognised that other stakeholders, either private shareholders, or indeed
in some cases, professional investors, who had no such access, might value assurance more highly:

*I think for professional investors they have access to the audit as everyone has, but they also have access to these [other] external reports which they use, so it is really the private investor who doesn’t get access to these things. Can they trust that what the company says is right because it is audited? These are the people you are thinking of when you talk about auditing management commentary.* (FM6)

While this fund manager rationalised management commentary assurance primarily in terms of the needs of private shareholders, an investment analyst usefully distinguished between different categories of professional investors:

*Investors are different and if you don’t know the company and you are concerned as to whether the management is good or not and you have no chance to meet the management because you are small you might benefit from assurance on management commentary. So it really depends on where you are in the industry and how well you know the business.* (BSA2)

One private shareholder commented similarly:

*If you are looking at protecting professional investors I think there is obviously a spectrum of experience but if you are looking at protecting private investors, they are less experienced at reading between the lines and are more likely to take narrative reporting at face value.* (PS3)
Whether fund managers or analysts have access to, or place reliance on, other information may depend, to an extent, on the industries on which they concentrate. Some fund managers and analysts specialising in particular industries appeared to be influenced by their ability to verify information, or because 'their’ industries were relatively straightforward. It reflects sell-side analysts’ use of corporate report information (see chapter four) that they were perhaps the most negative group in terms of the benefits of assurance. One stated that:

*The industry I work in [retail] is relatively simple to understand with limited flexibility to mislead. It is relatively un-complex. You buy materials, you add value to them and you sell them. So I would perceive only an outside risk of being misled. Secondly, the underlying numbers can ultimately be tied back to IFRS audited numbers so it would be difficult for a company to systematically distort or deceive around the underlying numbers and most companies would, indeed, provide reconciliations.* (SSA1)

This analyst was one of the interviewees who were most negative about the benefits of assurance on management commentary generally:

*Let's take Company C who have announced to the city goals of achieving mid teens operating margins by 2011. What is the benefit of auditors auditing that statement? At the end of the day it's management's view of what they are going to achieve. Analysts like me can take our independent view of how likely we think it is that they will achieve that given all sorts of benchmarking exercises, understanding of C’s internal economics and that sort of thing. I just feel that if the hypothesis is these things will benefit from auditing we are in danger of replacing a free market for information with something that is heavily prescribed and I think, ultimately, that will be to the detriment of good information flow.* (SSA1)
In other industries there may be a greater need for independent assurance. An independent check on Shell’s oil reserves, for example, might have revealed discrepancies or, at least, weaknesses in the verification procedures. The view of one fund manager was that:

*If you are, for example, a pharmaceutical company and you are looking at the drug pipeline, some reassurance would be appropriate. In a mining company some reassurance on health and safety, or processes pertaining to environmental policy might be appropriate.* (FM1)

Another fund manager, representing a very large organisation with a significant ‘public interest’ dimension, articulated a need for differing approaches to specific industries on the basis of the wider effects of organisations’ activities. He suggested that:

*Some things demand quite intensive audit. Companies in the oil and gas sector; companies that have a direct impact on the environment… I think that these are going to require a lot more work.* (FM3)

While some participants made the point that different industries presented distinctive challenges, distinctions were also drawn in terms of different management commentary content. In this regard, reference was made particularly to risk information and to the temporal dimensions of management commentary content. A distinction was made between factual, historic information, and softer information – which often had a future dimension:

*I’m interested in seeing management commentary audited because there will be some factual information about strategy, about process, planning risks, about what the risks are in an organisation – much as a prospectus will state thirty or so different risk factors and that*
is a legal document on which you can launch a lawsuit if you feel you’re being misled. I think to a similar extent there should be some audit role with respect to management talking about risks and processes. (BSA1)

However, this fund manager believed that while auditors opining on future information was laudable and he ‘would love to see it’, he believed that this was just ‘too difficult’. These comments are interesting, implying that commenting on risks is a more straightforward process than commenting on future forecasts; some might take issue with that. There was, however, a wide spectrum of investor views on the feasibility of commenting on future forecasts. One who was more sanguine on this commented that auditors could at least:

…look at the process and controls behind these forecasts; they can look at the assumptions... see whether the risks have been addressed and whether some risks have been omitted... build on Turnbull really. (FM3)

The business CFO interviewed was quite forthright about the benefits of assurance on future information despite the obvious difficulties. He expressed his view cogently as follows:

It’s always easier for anybody to comment on quantitative and past information. That’s easy to do and the benefit of hindsight is always that you have a clearer vision. Future, and particularly qualitative, information is obviously a much more difficult thing to comment on, but at the end of the day, to my thinking it’s the more useful part of it because what’s done is done — you can learn lessons from it, but it’s where you’re going in the future that’s actually critical to the future success of the business and how things move forward. So, my inclination is that it should be more towards present and future for the simple reason that’s what’s going to make a difference. (BU)
The possibility of assurance on future forecasts is discussed further in the following section on the scope of assurance.

Risk is one content element of management commentary where the importance of auditors operating ‘behind the scenes’ in discussions with directors was emphasised by several interviewees. In some cases this was seen as more important than auditors reporting formally to shareholders. It was recognised that, while auditors may have extensive knowledge of economy-wide business risks, client industries and client companies themselves, advice on risk [management] will inevitably be ad hoc. It was argued that auditors cannot offer assurance that all risks are identified and appropriately evaluated. Requiring them to report on these areas would not be feasible unless the reports were caveated to such an extent that they became meaningless:

Would auditors really come up and start highlighting additional risks? I very much doubt it. So what are they doing? Are they providing internal consultancy advice to companies? Let management say that they’ve taken professional advice – let it be what it is – risk consultancy. If the real output and product is someone providing a sounding board for management and for the directors let it be that. Let it not be packaged and imposed as assurance services that provide comfort. (FM8)

Generally, each non-investor group assessed the importance of assurance on management commentary generally, and on the particular content elements highlighted, as greater than the investor groups. The one caveat to this is that the ‘accountants in business’ assessed the importance of assurance on some management commentary content elements (nature of business, objectives and strategies and performance measures and indicators) as lower than did most investor groups. This may reflect their familiarity with these areas within their own organisations and concomitantly that they are inappropriate areas for auditors to opine
on. This concern was expressed by the CFO interviewed, suggesting that auditors might need to improve their in-depth understanding of client organisations:

> If management are commenting on where they see the business risks and any new initiatives they are developing then the auditors should understand the business they're auditing. I'm not clear that they always do that at the moment. They're too busy just completing their checklists and filling out forms in order to get the accounts signed off within the appropriate deadlines. I think they need to think more about the business itself and to comment on whether management is justifying its claims as to where the business is going and how it might be affected by changing circumstances. (BU)

What is perhaps surprising in these reflections is the suggestion that contemporary auditors, after continual reiterations of ‘new’ audit methodologies, may not understand the businesses which they are auditing. Remarks about the importance of ‘understanding the clients’ business’ no doubt resonate with generations of past audit trainees. These remarks are also consistent with the views of some interviewees on the robustness of the audit process; these are explored in chapter six of the research report.

The two representatives of the corporate social interest, who were interviewed together, also commented interestingly on both the arguable tendency for auditors to major on process and at the same time the limitations of such an approach when transported from auditors’ traditional financial statement comfort zone. The first interviewee commented in positive terms on the ability of auditors to get involved with CSR information:

> Auditors tend to be masters of process so if you have a (CSR) framework and say ‘this is the information that complies with the
framework’ then the auditor may be able to comment on either the accuracy of the information or the process that produced it. (CB)

His colleague, while very positive in principle on the desirability of assurance on CSR information, whether in the management commentary *per se* or elsewhere, expressed reservations as to the ‘fit’ of this with what she saw as the classic auditor predisposition towards ‘process’:

*I think that if corporate responsibility is done properly within a business it is very hard to have a process. By its very nature, it is not linear – it is cradle to cradle instead of cradle to grave. There are lots of things that would not fit a procedural approach – that is where I think the barrier may be.* (CB)

These comments are interesting in view of the questionnaire results, discussed in the following section, on preferences regarding specific assurance approaches – at the most general level there appears to be a discernible preference for a ‘process’ approach.

Views by non-investors on the need for assurance on management commentary were also varied …but without the argument that non-investors might have other and more effective ways of accessing the sort of information included within management commentary. The insolvency practitioner interviewed articulated the, by now familiar, view that there was a tension between the ideal and the practicable and expressed what might be regarded as an ‘expected’ response from a ‘Big Four’ representative:

*In an ideal world, I think [management commentary] should be audited, but I think there is also a concern that you can’t really hold the auditors accountable for absolutely everything. They largely only do what they’re given and while they can challenge and sense check and be a barometer for common sense, I think it would be quite a difficult thing for them to put their opinion to.* (IP)
The member of the Scottish Parliament was firmly of the view that assurance was needed to moderate unjustifiable management statements:

*An auditor should be able to say, ‘Well frankly that assertion in the company report is optimistic to the point of being absurd’.* (MSP)

In summary, the prevailing view is that there should be some form of assurance on the management commentary. The following section deals with the extent and scope of the assurance which might be put in place.

**The scope and extent of assurance on management commentary**

One objective of the research is to attempt to identify not just whether there is a demand by users for assurance but the extent and scope of that assurance. To that end, two questions were incorporated in the investor questionnaire. No such additional questions were incorporated in the non-investor questionnaire because this subject was considered to be of a more technical nature and perhaps inappropriate, therefore, for non-investors and also because a significant proportion of the respondents to the investor survey, especially those distributed on-line, ignored these questions or interpreted what they were being asked to do wrongly.

Both these questions asked respondents to rank their preferences (1, 2, 3) between three recognised forms of assurance – content, process and consistency. Each of these was defined for potential respondents within the questionnaire immediately prior to the questions themselves. The first question required respondents to choose between assurance on content, process and consistency for management commentary content characterised in terms of being: (i) historical or forward-looking; and (ii) quantitative or qualitative. The second question required respondents to make the same choice for the management commentary content elements highlighted by the IASB exposure draft (IASB, 2009). The results for these questions are shown in Tables 5.2 and 5.3 respectively.
Table 5.2  Ranking of different forms of assurance for management commentary content with different characteristics

<table>
<thead>
<tr>
<th>Ranked forms of assurance considered most appropriate for the following management commentary content</th>
<th>Total</th>
<th>FMA</th>
<th>FP</th>
<th>PS</th>
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<tbody>
<tr>
<td><strong>Audit of Historical quantitative financial information (e.g. sales)</strong></td>
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<td>Content</td>
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<td>Process</td>
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<td>Consistency</td>
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<tr>
<td><strong>Audit of Historical quantitative non-financial information (e.g. environmental emissions)</strong></td>
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<td>Content</td>
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<td>Process</td>
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<td>Consistency</td>
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<td><strong>Audit of Historical qualitative information</strong></td>
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<td>Content</td>
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<td>Process</td>
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<td><strong>Audit of Forward-looking quantitative financial information (e.g. future sales)</strong></td>
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<td>Content</td>
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<td>Process</td>
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<td>Consistency</td>
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<tr>
<td><strong>Audit of Forward-looking quantitative non-financial information (e.g. targets for emissions)</strong></td>
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<td>Content</td>
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<td><strong>Audit of Forward-looking qualitative information</strong></td>
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Note:

Aggregate rankings: 1 = most preferred    2 = next preferred    3 = least preferred

These tables display aggregate respondent preferences for the forms of assurance (content, process or consistency) considered most appropriate for the six characteristics (Table 5.2) or six content elements (Table 5.3) of management commentary. The results shown in these tables are given for all investors in total and are also shown split between fund managers and analysts, other finance professionals and private shareholders.
Table 5.3  Ranking of different forms of assurance for different management commentary content elements

<table>
<thead>
<tr>
<th>Ranked forms of assurance considered most appropriate for the following content elements of management commentary</th>
<th>Audit of</th>
<th>Total</th>
<th>FMA</th>
<th>FP</th>
<th>PS</th>
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<tr>
<td><strong>Nature of business</strong></td>
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<td>Content</td>
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<td><strong>Objectives and strategies</strong></td>
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<td>Content</td>
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<td><strong>Key resources, risks and relationships</strong></td>
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<td>Content</td>
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<td><strong>Past results</strong></td>
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<td>Content</td>
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<td><strong>Future prospects</strong></td>
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<td><strong>Performance measures and indicators</strong></td>
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**Note:**
Aggregate rankings:  1 = most preferred     2 = next preferred     3 = least preferred

Tables 5.2 and 5.3 require to be interpreted cautiously because of the lower response rate for the questions concerned with the ranking of the alternative assurance models and because some respondents may have misinterpreted these questions. While respondents who obviously misinterpreted the questions are not included in the analysis it is possible that some interpretation difficulties were experienced by respondents.
who appeared to interpret the questions correctly. Additionally, while an attempt was made to ensure that the definitions given in the questionnaire for ‘content’, ‘process’ and ‘consistency’ were as robust as possible there are obvious difficulties in interpreting ‘content’ or ‘consistency’ in the context of, for example, the ‘softer’ or future-orientated information that may be expected to form a significant proportion of many management commentaries. Assurance on the ‘content’ of future information may require imaginative approaches that go beyond traditional verification.

Nevertheless, with these caveats, the general picture that emerges is one where ‘process’ narrowly dominates ‘consistency’ as the most preferred form of assurance. Table 5.2 indicates that for all categories of respondents, as a whole, ‘process’ was the most preferred option for two categories out of six and the second most preferred choice for the remaining four. Similarly, ‘consistency’ was the most preferred choice in three cases, second choice in two cases and third choice for the remaining one case. For the content elements shown in Table 5.3, and for all categories of respondent, ‘process’, was most preferred for three content elements out of six and the second most preferred choice for the remaining three.

‘Content’ appears to be a clear third choice overall although Tables 5.2 and 5.3 do indicate that a ‘content’ form of assurance is the most preferred approach for ‘past results’ and for other past quantitative information.

The breakdown of results by investor group indicates some clear inter-group differences. Most obviously, Tables 5.2 and 5.3 both suggest strongly that the fund manager and analyst group is most inclined to a ‘consistency’ form of assurance. This appears to reflect both their less positive views, relative to the other two investor groups, on assurance on management commentary generally.

By way of contrast, Tables 5.2 and 5.3 indicate ‘other finance professionals’ exhibit the most robust approach to assurance of the three sub-groups with a clear preference for ‘content’ or ‘process’ over
‘consistency’. All groups, however, indicated ‘content’ as the preferred approach for quantitative and historic information.

These issues were explored further in the interviews. A variety of views was expressed on each of the three approaches to assurance. Although this issue was not addressed in the non-investor questionnaire, the opinions of non-investors on the issue were elicited where appropriate.

**Audit of consistency with financial statements**

Audit of consistency was generally envisaged as a minimum desired level of assurance by interviewees across all categories, even by those who were least positively disposed towards assurance on management commentary.

*I think that auditors obviously have to verify the financial figures and then I think they need to ensure consistency with the other matters that are reported. I would be concerned if it went further than this. Just ensuring consistency, that is reasonable.* (IR)

*I think it is difficult to have anything more than an opinion that the information is consistent with the financials.* (SSA2)

There was some suggestion, particularly among non-investors, that auditors should be doing this already:

*It’s the auditor’s job to deal with the numbers. It is not to deal with the narrative unless they feel that the narrative flies in the face of the numbers. If the narrative was massively inconsistent with the numbers, then it would be incumbent on the auditors to say so.* (MSP)
I think you certainly would want to know it was consistent and one would make the automatic assumption that it was unless somebody said otherwise. (BU)

However, a number of interviewees thought that there was a need for more than assurance on consistency. For example, one professional investor expressed his view as follows:

I would expect consistency as an analyst but I would hope that the management statement would tell me something about strategy and outlook and risk, which might not be contained within the numbers. So to me consistency is the bare minimum I would expect and I would hope for more. I hope that more would be either checked in an audit sense or at least expose the company to a check that they are not misleading. I guess I’d veer towards an audit that gives a reasonable outlook or a reasonable forward-looking statement or reasonable assessment of risks. (BSA1)

There was specific mention of a ‘reasonableness check’ by several interviewees. On occasion, discussion on consistency spilled over into a discussion about reasonableness:

I would probably err on the side of a reasonableness check on what they have actually written in the report; for example, is there something blazingly obvious like they say sales are up 10% when actually they are down. ‘Reasonable’ here means looking over the past and seeing what the management have said and asking if it reflects reality. I think that’s something that is finely balanced. In general, my preference would be for commenting on the consistency. (FM6)
On it being suggested that his preferred approach appeared to be rather more robust than a mere consistency approach, this fund manager replied:

*Well, yes. Consistently reasonable!* (FM6)

The next level of assurance involves reviewing the robustness of the processes followed by organisations when writing management commentary.

**Audit of the processes underlying management commentary**

Although a minority of interviewees were positively disposed towards auditors reviewing company processes, a considerable number expressed reservations about what this might achieve and queried whether it would add any real value. Those who were positive about the audit of process tended to envisage its use primarily in respect to the future-orientated aspects of management commentary and the discussion of business risks. However, most investors did not think that the audit of process would add significant value:

*I think the audit of process is not much use. It's a bit like the banking, level 1, level 2 and so on and the process of modelling, so audit doesn't really seem to add much.* (FM7)

*I imagine some people looking at their assessment of risk and saying: 'Well this is the process we've followed: we had a committee, we met, we drank some coffee, we drew up twenty ideas, we printed it, we arrived at seventeen and so on.' I've seen the diagrams where they throw in different boxes and arrows and all that does is give me the impression that they have thought it through but it doesn't*
help me as an analyst other than to give me a feeling that they have followed a process. (BSA1)

Things management say get extraordinarily intensely scrutinised but there are a whole range of informal processes. I just don’t see what auditing brings to the party. (SSA1)

My concern over process is that it is just so vastly different between categories and companies so I can’t really form a view on whether audit of process would add value or just be an extra cost. (FM10)

Two professional investors suggested that documenting formal processes to provide a basis of statements in management commentary would result in the development of narrative reporting becoming even more ‘hidebound’ than at present. Perhaps informally produced reports were better:

The best business review that I have read is that of a company called Company G which is not even in the top 350. It is a small concern and you can see that the chairman has written the whole of the business review. The tone just goes through seamlessly and you can see that he is being honest and direct. You don’t need a process. You don’t need a check on the process to get that comfort over it. (FM2)

There is an apparent disconnect between these rather negative comments on a process approach and the results from the questionnaire survey which appeared to signal that, a process approach was by a narrow margin the preferred option of respondents in general. However, this was not the apparent view of fund managers and analysts at the interview stage of the research.
Audit of content of management commentary

A minority of interview participants did believe that auditors should be responsible for the audit of management commentary content and expressed this view firmly, recognising that this would also embrace the audit of process and consistency. One fund manager expressed his view as follows:

*I feel that what we shareholders are looking for is for the content to be reviewed by an audit firm rather than the consistency of what is being said. We are going to be far more comfortable with that. I think that in reviewing the content by default you will be looking at process and consistency.* (FM5)

This fund manager was positive as regards a ‘content’ audit not just of past and present information but of future forecasts:

*Yes, an audit would probably be asking for verification from the management team of any forward-looking remarks that they were making and it’s probably not much different from anybody going through any formal document which is being endorsed by a lawyer where there is a prospective dimension for a company and where there are verification notes. It may not be as detailed as that but if management are saying, for example, that ‘we expect our market to grow by 10% per annum’, these are the sorts of things that you would expect them to substantiate.* (FM5)

This interviewee did acknowledge however that:

*It would be a [far more] complex area for auditors to become involved in if they are actually required to give some sort of*
assessment of the validity of any forecasts which are included in management commentary. (FM5)

On the other hand some investors made the point that the temporal dimension made a difference when talking about the assurance on content. It would be unreasonable to expect the same level of assurance for all temporal dimensions. Information on past results may be auditable:

*You can argue that there is a difference between explanation of past events which is factual information and speculation on the future which is more an expression of judgment so as far as the past is concerned I would be more positive.* (FM10)

*Past results are easy. The existing purpose of the audit is to test the historical accounts.* (FM3)

This fund manager, however, was clear that, whatever the time dimension of the management commentary information, the assurance approach needed to be rigorous. When asked his view as to whether a ‘lighter touch’ approach was appropriate for future information he replied that:

*A lighter touch is now a dated phrase isn’t it? I would say it has to be effective, which isn’t the same as saying it has to be heavy handed.* (FM3)

Nevertheless, there was less enthusiasm for auditor involvement in expressing an opinion on future information. It was argued by some interviewees that it would be hard for auditors to challenge sophisticated management in large organisations because of the information asymmetry between them. Concern was expressed as to whether auditors
had the knowledge and expertise to challenge management in relation to forward-looking information.

The MSP interviewed recognised the difficulties faced by auditors in this regard:

> Auditors don’t have crystal balls any more than the rest of us and they themselves might have some doubts as to a particular course of action or direction of the economy for example so it’s a bit difficult to see how an auditor can comment with tremendous authority in that respect. (MSP)

Some professional investors also highlighted these difficulties:

> I would think that the moment the auditor went to the CEO and said, ‘I don’t think you can meet your target,’ I guess the CEO would say ‘What do you know about my industry?’ (SSA3)

> It would be a very brave auditor who said that the chief executive is wrong… Asking auditors to take a view on prospects for the business is quite challenging because auditors don’t run businesses. We use accountancy firms to do due diligence on businesses that we are contemplating buying. Trying to get the accountancy firms to give you any view on the likelihood of achieving these forecasts is nigh on impossible. All they will tell you is that arithmetically they are put together properly and if you are lucky they will say it looks sensible given past performance. (FM6)

This comment on whether or not forecasts appeared ‘sensible’ resonates with the view that, while it was unreasonable to expect auditors to opine on future information in the same way as historic information, they could at least say something:
It's only a forecast but there has to be evidence to substantiate it. (FM5)

The distinction between the different levels of audit assurance begins to look blurred here. Auditors may look for evidence to substantiate forecasts based on the processes that management have used to arrive at the forecasts and may also derive additional comfort from the consistency of the forecast with their own knowledge obtained from the audit. Arguably an examination of management assumptions constitutes an audit of content in the context of future information:

At the end of the day if you're looking at projections that will be management opinion and may be held in good faith but it doesn't stand up compared to historical or present economic conditions. (SSA2)

From the perspective of both directors and auditors, the over-riding fear is of making statements that are a 'hostage to fortune' in a litigious environment. As one fund manager observed:

When I'm writing an outlook statement I'm always careful about what I say and if anything I'm always on the prudent side, so I can understand why an auditor might be a little cautious but I think there is a compromise they could reach with management on these outlook statements. The only problem we have with this is if the auditors and management are concerned about any liability then you end up with an outlook statement that doesn't actually help anyone. (FM4)
It may be that ‘safe harbours’ for both directors and auditors, or alternatively, extensive caveats would encourage helpful forecast statements. In the opinion of a private shareholder:

*Crystal ball gazing should probably be left to management but with caveat emptor written all over it.* (PS1)

One fund manager made the point that whatever approach was adopted it was important that it was clear what was audited, and to what extent, and what was not:

*In management commentary there are some numbers – quite specific ratios – where I think there is an illusion that they are being audited at present. I find that boards and users don’t readily understand the distinction between what is not audited and what is.* (FM7)

Thus, there are a variety of perspectives on management commentary assurance. The next area explored was the cost implications of assurance.

**Cost implications of providing assurance on management commentary**

In general, cost was not seen by interviewees as a significant obstacle to effective management commentary assurance. The investor questionnaire survey indicated a possible figure of up to around £100,000 for an audit of content. One fund manager, a corporate governance specialist, commented on this as follows:
My first reaction was that even for the Rolls Royce service – the audit of content – the £100,000 at the top is a price that investors ought to pay. (FM3)

However, a management commentary audit of content for the largest companies, e.g. major banks such as RBS or HBOS, would be likely to cost far in excess of this figure. The same fund manager commented that:

That would cost millions, but then these are multi billion turnover enterprises. Before the dive in bank capitalisation, HSBC, one of the biggest banks in the world, had a hundred billion in capital; to spend three or four million on a very rigorous review of their activities that would give reassurance to shareholders is not excessive, I think. (FM3)

The investment industry representative held the opinion that cost was not significant factor as to whether or not to require assurance on management commentary:

I don’t think it is something that concerns investors; it is a drop in the ocean on the scale of things. (IR)

It was the view of one fund manager (FM2) that there should not be a step change in costs because there isn’t a step change in what is required. While this fund manager was relaxed about the prospect of assurance on management commentary adding five or even ten percent to the overall cost of the audit fee, an alternative perspective was that:
The starting point should be what you think is the right thing to do and then you should cost it; if it is too expensive then you need to think of the next best thing to do. (FM9)

Thus the consensus opinion amongst investors appears to be that cost should not determine the scope of the assurance option selected. While cost considerations are an issue that was raised primarily with investors, two other stakeholders expressed interesting and contrasting opinions on the issue. One, an insolvency practitioner, and partner with one of the ‘Big Four’, believed that cost was a significant issue in terms of the likely quality of any management commentary assurance and indeed, she believed that this was significant in the context of existing assurance practice generally:

I think that the challenge would be that it would increase audit fees significantly... I think I was looking at something where there was an analysis of the big firms in terms of the big tier and the smaller tier and I was quite shocked at the gap that had grown between the now ‘Big Four’ and even the middle tier in terms of the average fee. I cannot for the life of me see how someone can sign off an audit for the sort of sums of money that we see coming through some sets of accounts. (IP)

This viewpoint was quite different from that expressed by the representative of a major public sector environmental organisation. It should be appreciated that the main focus of his interest would have been on any environmental aspects of management commentary assurance:

I was a consultant for a university and typically I would see this kind of work... coming in about the £3-4,000 mark. I have heard other organisations coming back at £15-20,000 for doing exactly the same work. So you get the chancers, the big boys and girls,
who try this on... maybe that’s just the way that they do business, but I quite like value for money... So I don’t see cost as inhibiting it too much. (EA)

In summary, the views of users suggest that cost should not be significant in determining how management commentary should be approached.

Implications for audit firms

Some interviewees suggested that for external auditors to comment on management commentary would have implications for the skills base of audit firms. Some thought that auditors already possessed the necessary skills or that individuals with these skills could be recruited readily by the firms.

I think the firms need to develop and evolve but skill sets can be bought in, but I don’t think that we want to get too specialised on this. I think it is actually coming back to a general purpose auditor, as it were, who in many areas of narrative reporting should be able to ask and seek and to be satisfied through the interrogation process and get answers to a reasonable user’s expectations. A specialist could go off down a specialist siding – we then discover that we are working with minutiae. (FM1)

I’m sure they will be able to work out a way to do this without having to take on a lot of extra people. The skill set should be there anyway. (FM4)

I would have thought that the staff of an audit firm shouldn’t have any difficulties in making an assessment or reviewing management commentary because they have to build up a store
of knowledge about a particular client in order to allow them to actually undertake the audit... I think nowadays the audit firms are much more interested in looking at the economic and competitive environment in which a company is operating, in order to give them a starting point to actually plan their audit... (FM5)

While admitting that his knowledge of audit practice was out of date, this fund manager dismissed the argument that auditors would have to radically revise their staff mix to review management commentary:

The idea that they would have to start building huge new teams in order to provide this audit review of management commentary doesn’t strike me as being a requirement... but I think I can see perhaps the audit firms might be using that argument as a basis of arguing against the role they could play in that area but I’m not sure it’s really valid. (FM5)

Some interviewees, however, thought that the necessary knowledge would lead to increasing industry concentration and create further barriers to a widening of the large company audit market:

Clearly the scope goes beyond financial statements and into areas that cover risk. Obviously there are a whole set of skills that will be required. One of the issues may be the need to contract in specialists rather than purely proprietary ownership of all the skills and obviously there are commercial and cost considerations to try to be able to cover everything. I think it also has some interesting implications for the wider audit markets in terms of availability, choice and competition. (FM8)
Concern was expressed that a further consolidation of the ‘Big Four’ audit firms would restrict audit choice even further. If specialist skills were required for reporting on management commentary, it might only be the very large firms who could afford to employ such specialists. If left to the market it was unlikely that shareholder choice of auditors would ever be widened beyond the present ‘Big Four’. The best approach was not, it was argued, to try to persuade the larger medium-sized firms to break into the ‘Big Four’ market. Instead:

*The question is whether there is any regulatory intervention required to actually bring back the ‘Big Eight’ and then naturally have a ‘Big Ten’ with a more level playing field financially.* (FM1)

There were also some concerns about the ‘process-driven’ nature of contemporary auditing and, in many cases, the relatively limited business experience of many auditors; even those at relatively senior levels. These are general issues, and are therefore discussed in more detail in chapter six, but they may have implications either for the profession’s capability to provide meaningful management commentary assurance or, at least, for user perceptions of this capability.

There were mixed opinions, then, on whether or not auditors possessed the skills to report meaningfully on management commentary. While there were some exceptions, many interviewees, however, believed that audit firms should be able to provide assurance on management commentary with relatively little adaptation.

**Communication of assurance on the management commentary**

Questions of whether or not there should be assurance on management commentary, and the scope of that assurance, give rise to the further issue of how assurance should be communicated to shareholders.
and other stakeholders. To this end, a question was incorporated in the investor questionnaire, but not the non-investor version, to elicit investor perceptions as to the best way of communicating assurance on management commentary. The results for this question are displayed in Table 5.5.

**Table 5.5 Methods of communicating assurance on management commentary**

<table>
<thead>
<tr>
<th>Methods of communicating assurance on management commentary</th>
<th>Total(^1) M</th>
<th>SD</th>
<th>FMA(^1) M</th>
<th>SD</th>
<th>FP(^1) M</th>
<th>SD</th>
<th>PS(^1) M</th>
<th>SD</th>
</tr>
</thead>
<tbody>
<tr>
<td>The standard audit report.(^{1,2})</td>
<td>2.43</td>
<td>1.04</td>
<td>2.86</td>
<td>1.03</td>
<td>1.96</td>
<td>1.04</td>
<td>2.27</td>
<td>1.03</td>
</tr>
<tr>
<td>A longer ‘company-specific’ audit report possibly including commentary on the audit work.</td>
<td>2.68</td>
<td>0.99</td>
<td>2.94</td>
<td>0.98</td>
<td>2.46</td>
<td>1.14</td>
<td>2.56</td>
<td>0.91</td>
</tr>
<tr>
<td>A standard audit report specifically on the management commentary.(^{1})</td>
<td>2.93</td>
<td>1.06</td>
<td>3.22</td>
<td>1.06</td>
<td>2.96</td>
<td>1.00</td>
<td>2.67</td>
<td>1.11</td>
</tr>
<tr>
<td>A longer ‘company-specific’ audit report specifically on the management commentary possibly including commentary on the audit work.</td>
<td>2.95</td>
<td>1.02</td>
<td>3.02</td>
<td>1.02</td>
<td>3.08</td>
<td>0.84</td>
<td>2.83</td>
<td>1.12</td>
</tr>
</tbody>
</table>

Notes:

1. Significant difference at 5% between mean scores for fund managers and analysts and those for private shareholders.
2. Significant difference at 5% between mean scores for fund managers and analysts and those for other finance professionals.
3. No significant differences at 5% between mean scores for each method of communicating assurance on management commentary for either investors generally or for each investor sub-group.

Legend: 1 = Very desirable  2 = Desirable  3 = Neutral  4 = Undesirable  5 = Very undesirable
Four alternative ways of communicating assurance on management commentary were proposed. The first two of these, the ‘standard’ audit report and a longer (general) ‘company-specific’ audit report, did not involve a separate report on management commentary. The third and fourth alternatives each involved a separate report on management commentary. The results shown in Table 5.5 indicate that these latter two alternatives are regarded less favourably by investors, both generally and by sub-category, than those that would provide assurance on management commentary within the general audit report. There were, however, no significant differences at 5%, on the basis of a one-sample Kolmogorov-Smirnov test, between the mean scores for each method of communicating assurance on management commentary awarded by either investors generally or by each investor sub-group. The most popular option was that assurance on management commentary be communicated in the standard audit report with 53% of respondents believing it was desirable or very desirable. The alternatives involving a separate report on management commentary were both regarded as desirable or very desirable by only 35% of investors.

Investors also tended to prefer ‘standard’ audit reports, as offered in the first and third alternatives, to longer ‘company-specific’ versions, as offered in the other two options. While not the main intent of the question, this result is somewhat anomalous in that, prima facie, it conflicts with the results relating to perceptions as to the value of audit reports and how these might be enhanced. These are discussed in chapter six of this report and indicate that investors are unenthusiastic about existing standard audit reports but perceive proposals to enhance these positively, including the incorporation of company-specific information. This implies that investors may have interpreted the term ‘standard audit report’ in the current question more generally than as referring merely to the current UK standard audit report mandated by extant auditing standards.
Fund managers and analysts scored each alternative lower than did both private shareholders and other finance professionals. This reflects both the lower importance which they as a group place on the assurance of management commentary as well as their more modest view of the existing audit process and existing audit reports. These results were reinforced by interviewees’ comments:

...I think if we’re looking at an audit then all the elements of the auditor’s responsibilities should be brought together in a single audit report. (FM8)

The more things that are put in the same place the more helpful it is. (IR)

I think it would make more sense to have it all in one place, from the point of view of shareholders, investors and users of the report and accounts. At least you know that there is one section of the report and accounts – a page or two pages – which is the preserve of the auditor... So I think it makes sense to have everything that is related to audit commentary in the one place as opposed to being potentially dotted about and across a number of pages. (FM5)

However, a minority view expressed by a fund manager and by a business user was that the auditor’s comments on management commentary should be set alongside the statements by management in the commentary:

Wherever your management commentary is, I guess that is where you want to be highlighting the areas of weakness. You want them in the same place. You say you are proud to announce that sales hit a billion this year and then you go to page 53 of the audit report and see that there is a question over revenue recognition... You are
at risk of not seeing it, jumping back and forth. Much better to say ‘We are pleased to announce sales of a billion but the auditors say it is two hundred million less’. (FM6)

The clear consensus, however, is to have one audit report on both the financial statements and the management commentary.

Summary

This chapter has examined external assurance on the management commentary. The following points can be made:

• In the case of both investors and non-investors there is a reasonably strong view that some external assurance should be provided on management commentary. As far as the investor groups are concerned, fund managers and analysts are less positive about the importance of providing assurance on the management commentary than the other two investor groups. This appears to be the case, particularly with analysts, reflecting the much lesser degree of importance which they attribute to management commentary. Over all respondent groups there is a significant diversity of view.

• There was widespread agreement, even among those unconvinced by the need for auditor involvement, that auditors could be expected to report on the consistency of management commentary with the financial statements as a minimum standard.

• At the interview stage, those research participants who were positive about auditor involvement cited the alleged inconsistencies between narrative statements and the hard data currently subject to audit. They also argued for auditors to curb the excessive optimism in directors’ statements and to encourage directors to be more transparent in the information provided.
• Interviewees who did not support auditor involvement argued that auditors would not be able to report meaningfully on director statements because they lacked the resources to challenge directors in subjective areas such as strategy, risk management and future prospects. There was concern that having statements audited would reduce the quality of disclosure and increase the use of boilerplate language.

• It was acknowledged by fund managers and analysts who did not see a strong necessity for assurance on management commentary that, while they were able to form an opinion on the accuracy of management commentary from the other evidence available to them, such evidence was not available to small investors or, indeed, other financial statement users and, for them, auditor assurance might well provide some comfort.

• A variety of views were expressed on the audit of content. Generally, it was suggested that historic, factual content could be verified but that statements of risks and forecasts for the future were less susceptible to verification. Some participants, however, argued for the feasibility of a robust approach to assurance on future information. Consultation with directors on risks before the management commentary is produced could moderate excessive optimism and the omission or defective evaluation of significant risks. However, it was recognised that auditor involvement in this area would tend to be ad hoc rather than comprehensive in nature and that any opinion expressed would not be able to be expressed in true and fair view terms.

• On softer information it was suggested generally that auditors could report in ‘softer’ terms including comments to the effect that the information was ‘reasonable’ or ‘not unrealistic’ in the light of information known at the time. This could give some degree of comfort to users who had no access to the reports and briefings used by fund managers and analysts to triangulate evidence. However,
there was concern expressed by one or two interviewees that such reports might raise fears of auditor liability problems and it may be necessary to develop safe harbours for both directors and auditors to offer some protection against litigation for statements made in good faith which subsequently turned out to be incorrect.

- Thus both investors and non-investors placed relatively greater emphasis on the assurance of the more obviously ‘verifiable’ content elements of management commentary such as ‘past results’ and ‘key resources, risks and indicators’. Views on ‘softer’ content elements of management commentary, such as ‘future prospects’, were less positive.

- Opinions were elicited only from the investor groups as to the most appropriate form of assurance that might be applied to management commentary. The more robust ‘content’ form of approach was generally seen as more appropriate for the more factual aspects of management commentary; similarly the ‘lighter-touch’ approaches – ‘process’ or ‘consistency’ – for the more subjective or qualitative or subjective aspects of management commentary.

- There were some apparent differences between the three investor groups as to their preferred form of assurance. The fund manager and analyst group, in general, expressed a preference for a ‘consistency’ approach and this is congruent with their generally less enthusiastic stance relative to the other investor groups on the need for assurance on management commentary. By way of contrast, other finance professionals, in general, were most in favour of a ‘process’ form of assurance.

- However as far as those research participants interviewed were concerned, especially fund managers and analysts, there was little enthusiasm for reporting on the processes involved in producing the information because there was such a variety of possible approaches
that auditor comment was not likely to be meaningful. Also, it was not the processes that determined the accuracy of statements, but the quality of the people writing the statement, which went beyond process.

- The need for a holistic approach to corporate reporting and the assurance aspect of it was emphasised. At present there is confusion over which sections of an annual report are being audited.

- Cost should not be a significant driver of the chosen approach to providing assurance on the management commentary. There were interesting comments by interviewees on the implications of providing assurance on management commentary for audit firms. While several individuals stressed that audit firms should be able to adapt to providing assurance on management commentary with relatively little difficulty, others mentioned the ‘process’ driven nature of contemporary audits, as well as the relative lack of experience of many audit staff, as possible obstacles.

- Investors were asked about their view as to the most appropriate vehicle for communicating assurance on the management commentary to users. The preference over all groups appears to be that this should be communicated within the standard audit report on the financial statements rather than becoming the subject of a separate stand-alone audit report.
Introduction

The final set of research issues concerns the effectiveness of the external audit function. The rationale for widening the research to include these issues is that considering views as to whether or not external auditors should report on management commentary naturally prompts extension to the scope and value of external audit reports generally. These views, in turn, are likely to at least partially reflect stakeholder perceptions of the value of the audit process which underpins auditors’ public reporting. Additionally, a focus on the more qualitative and judgmental information which is likely to feature within management commentary may create an opportunity to refocus the audit in a way that provides more benefit to stakeholders. These issues have particular resonance after the recent experience of corporate failure, and near corporate failure, within the financial sectors of the UK and many other leading economies. The general pattern has been that these failures occurred without being signalled in prior audit reports; this underlines issues about the robustness of audit processes and audit reporting.

The final two research questions addressed in this stage of the project, therefore, investigated the confidence of research participants in the value of the audit process and of audit reports generally and explored views on how the usefulness of each of these dimensions of the audit might be enhanced.
Value of the audit process

Investor and non-investor opinions were sought as to confidence in the existing external audit process. The results are presented in Table 6.1.

Table 6.1  Confidence in the external audit process

<table>
<thead>
<tr>
<th>Panel A: Investors</th>
<th>Total</th>
<th>FMA</th>
<th>FP</th>
<th>PS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
</tr>
<tr>
<td>Confidence in the external audit process</td>
<td>2.84</td>
<td>0.96</td>
<td>3.04</td>
<td>0.96</td>
</tr>
<tr>
<td></td>
<td>2.54</td>
<td>0.98</td>
<td>2.79</td>
<td>0.97</td>
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<table>
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<tr>
<th>Panel B: Non-investor stakeholders</th>
<th>Total</th>
<th>IP</th>
<th>AB</th>
<th>OS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
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<tr>
<td>Confidence in the external audit process</td>
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<td>2.67</td>
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<tr>
<td></td>
<td>2.88</td>
<td>0.88</td>
<td>2.71</td>
<td>0.69</td>
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</table>

Notes:
1 No significant differences at 5% between mean scores.

Legend: 1 = Agree strongly  2 = Agree  3 = Neutral  4 = Disagree  5 = Disagree strongly

These results show, at best, mildly positive confidence in the external audit process. There is, however, a wide dispersion of views, as indicated by the standard deviation and the spread of responses, and at the risk of over-simplicity the best descriptor of respondents’ views in general may be ‘ambivalent’. Over 20% of those responding to this question from the three investor groups scored themselves as either ‘unconfident’ or ‘very unconfident’ in the audit process. Almost all the remaining investor responses were split approximately evenly between those who were ‘confident’ and those who were neutral about the audit process.
It is perhaps noteworthy, however, that only two investors described themselves as being ‘very confident’ in the audit process. The responses to the non-investor questionnaire demonstrate a very similar pattern overall with again around 20% of respondents describing themselves as being ‘unconfident’ or ‘very unconfident’ in the audit process and with only one individual who was ‘very confident’ about the audit process.

Overall, the two single groups which appear to regard the audit process in the most positive light are ‘other’ finance professionals and, possibly unsurprisingly given their attachment to professional accounting firms, insolvency practitioners. Of all the surveyed groups, the key investor constituency of fund managers and analysts demonstrates the lowest mean level of confidence in the audit process. There appears to be a significant element within this key group with major concerns about the robustness of the audit process.

On the basis of these questionnaire results alone, the apparent lack of confidence in the audit process signals, at the least, a mild note of warning to the audit profession. The interviews explored stakeholder views on the issue in more depth and the concerns of interviewees reinforce the questionnaire results – sometimes dramatically. Some positive commentary on the contemporary external audit process emerged from the interviews, although there were a limited number of such comments, which tended to be related to contemporaneous business and environmental factors. One fund manager commented positively on developments within the audit profession post-Enron:

*I think that auditors, post-Enron really, have brought in more rotation of audit partners and we certainly see more attempt to review internally and get within audits a clearer view of what's going on. So, I genuinely have seen them since Enron behave in a different way and think that in the case of audits on any sizeable companies, there will be a lot of cross checking by at least two senior people or people from different offices, so I think that a lot has changed.* (FM7)
There were also a few more general comments of a positive nature made by fund managers or analysts. One commented that:

*I do trust a set of audited accounts I have to say. Fundamentally I expect them to present a true and fair view.* (FM6)

A few participants made some comments on auditors in the context of the contemporary financial and economic crisis which might be read as commendatory to varying extents or, at the least, as appreciative of the difficulties faced by auditors, particularly within the financial sector. One fund manager, when asked about his confidence in the external audit process given the recent turn of events within the financial and related sectors, put it eloquently thus:

*I ask myself a question: if I have a company that has produced an audited set of accounts do I feel better about it that than a company where I don’t have a set of audited accounts? I do – a set of accounts signed off by the auditors is a valuable thing for me as a shareholder. I think that the last 12 months have been so extreme that I am not sure it is the best example on which to base future audit policy because I think the banks in particular were set up and capitalised to manage two or three bumps in the road and we have had ten bumps in the road – I don't think they were set up to drive over ten bumps and that is a collective mistake made by shareholders, regulators, bankers as well as auditors. I don't think that these issues should be separated from debates on auditors, but they should perhaps be slightly set to one side.* (FM9)

*In a sense it is one of the first financial crises for a while where the first question hasn't been ‘where are the auditors?’ I think there will be some questions about the auditing profession in time. But I think there are more obvious, and frankly, more guilty, parties*
and therefore probably the profession is relatively safe in this case. There must, however, be some reconsideration of how complex instruments are accounted for and therefore how they are audited and I guess that over the coming couple of years we will make some progress on that. But there are clearly much more guilty parties than the audit profession. (FM2)

More measured and reflective perspectives on contemporary audits such as this tended to be made by professional investors but not by private shareholders. Other comments by professionals highlighted what they saw as the inadequacies or failings of auditors while being still appreciative of the difficulties faced by them in the very recent past. The accountant in business adopted quite a moderate stance:

*I think that the auditors of the banks were inadequate even to challenge some of the assumptions because I don't think many people actually understood some of the issues that were going on. So I think that it would be unfair to challenge the auditors particularly.* (BU)

Almost all comment of this nature, however, came, as might be expected, from fund managers and analysts:

*Yes, I'm sure it is simply a question of time before we get to a point where we again ask 'where were the auditors?' You look at some of these banks which have had to be nationalised and 'what was going on?' Did auditors understand the business model of an organisation like Northern Rock and did they understand its dependency on wholesale markets to access funds? You could I'm afraid make that criticism of the FSA and other institutions as well so the auditors are hardly on their own on this one. But I think we're right to expect that we will see a rise in perhaps the*
number of cases where the auditors will feature in the headlines as having missed some important thing that might have helped to appreciate what was actually happening. (FM4)

I think the auditors have got an incredibly difficult job but they have been remarkably unchallenged in the current crisis. We have really heard nothing about where were the auditors when all this was going on – which is remarkable. One example that I do remember – and which I still don’t really understand – is RBS because I am an ex-RBS man. They had their audited accounts signed off in about March this year with their big provision. And six weeks later they launched a 12 billion pounds rights issue and announced six billion pounds of bad debts – which six weeks previously hadn’t existed. It is staggering how you can do that although I am sure there must be a technical reason. (FM6)

Another comment – by an analyst – also focused on RBS and in its criticism of auditors in that particular case, gave just a suggestion of a future ‘moderating’ role for auditors in relation to management expectations (perhaps within the management commentary) and also perhaps a hint of how auditors might have helped explain the complexities of contemporary financial reporting.

When you look, for example, at the accounts of RBS in the end of last fiscal year they were so cheerful about the business prospects and the value for shareholders and look at the problem now! Auditors might have moderated that cheerfulness. When people invest money they accept the risk of loss but they really have to understand what they invest money into. Look at the balance sheet and the P&L, and explain to yourself why this company should have three billion equity and three trillion assets. Where are the assets from, what are they? (BSA2)
The representative of the trade union movement was quite forthright on the likely limitations of audit firms:

*It is not something the STUC has a position on but our work over the last six months has raised a number of issues. I think it is reasonably clear that there have been systemic failings which have contributed to where we are and you wonder about the ability, skills and experience within auditing firms to audit companies, investments or products that they don’t understand. I think it is giving companies, particularly in the financial sector, some leeway to spin the position even to supposed experts. I suspect that auditing firms haven’t really kept up to date with these complexities. It has been said there is a problem in that the people who do understand these things are not going to be working for the auditors. (TU)*

While this comment may not be representative of stakeholders generally, it is interesting as apparently indicative of opinions on the audit profession that may be held by influential strands of opinion within a major stakeholder group.

Some of the comment relating to the current environment, and made by private shareholders, verged on the vitriolic. Examples of comment by two different private shareholders follow:

*I have written off the audit profession. I’m not saying that 55% of audits or annual reports can’t be believed, but I think that probably 20% of them can’t be believed and 35% of them are dubious. (PS2)*

*With what we have seen in the markets over the last few years, I don’t see how one can give any credibility to any of the audits that have been carried out in the financial sector. You have a junior team of auditors who are actually doing the grunt work. Let’s be*
honest they’re the guys doing it and they’re not the most competent by virtue of the fact that they’re at the bottom of the food chain. They’re not the senior partners who may often sign it off. You’re going to send 200 of your junior associates into a large company and they’re going to crawl around not wishing to upset the senior management in the various companies. (PS4)

This interviewee’s understanding of contemporary audits may have been imperfect but the extract is interesting as indicating a view of external auditors which may be held by significant strands of private shareholder opinion; in this case by an individual who derived his principal income from share dealing. Nevertheless, the predominant tone of interviewees generally, on auditors’ performance in the recent financial crisis, while essentially negative, was moderated by an appreciation of the real difficulties faced by auditors.

Many comments reflected more fundamental concerns about the robustness of the audit process. Interviewees’ remarks tended to divide along the lines of two principal themes. Firstly, there appear to be quite widespread concerns about what was perceived to be a process-driven approach to audits linked to reservations about the prevailing business model adopted by auditing practices. Secondly, there are concerns about the prevailing organisational arrangements e.g. the appointment and remuneration of auditors for external audits and related concerns about auditor independence.

Several investors commented on what they saw as the relatively mechanical way in which audits were conducted, reflecting to some extent the business model of the audit profession. Interestingly, the fund management industry representative was a prime example, despite having himself trained as a chartered accountant with one of the ‘Big Four’.

Possibly the chartered accountant qualification could be modified so that it actually addresses the quality of the audit process more. You feel that these people are just sucked into the audit firms and
then it is all based on generating revenues. Most work is done by people with no business experience but how do you teach that unless you have actually got people out there who are actually engaged in business? The business model of the firms is such that you have these pyramid structures – you recruit and train and you expect a certain proportion to leave. The pyramid structure is not replicated in other professions because it is a resource intensive exercise. We have looked at whether or not there is obviously competition – and choice is an issue with the Big Four – and whether or not additional capital in the firms would help create other firms and outside interest. But my view is essentially that they are quite low capitalised businesses and the main resource is people. We think that there is insufficient emphasis on quality. (IR)

One fund manager saw the primary problem with contemporary audits as not just an excess emphasis on process but also a loss of professionalism and the exercise of judgment:

_To the extent that we have concerns about auditing, the nub of our concern is the question of professionalism within the profession. What is a profession? It is a self regulating group of people who operate in a particular business, who set standards of behaviour for themselves, and call each other to account for living up to those standards. Increasingly the standards of auditing are being set, not by the profession, but by external bodies – and we all know why that is; because confidence has been lost and so on. The confidence that members of the profession have to actually act professionally is I think a bit doubtful; I think that crucial element of exercising professional judgment is not as clearly established at the heart of what auditors do as it used to be. I am not one of those who think it is all lost, and all audits are done badly, but I think there is a risk that the profession has lost its professional nerve._ (FM2)
When asked about whether he thought that there was too much contemporary emphasis on auditing standards this fund manager replied that:

*I think there is a risk that there has been too much detail ploughed into these things. And that shouldn’t stop the best auditors doing the audit in the right way but you can imagine that less confident, perhaps less competent, auditors, see the rules first and almost exclusively, and don’t step back and see the bigger picture and – this is actually what the auditor is here for, not to follow this or that checklist – exercise judgment.* (FM2)

The remarks of this fund manager – who was employed in a senior capacity by one of the largest UK investment houses – are thought provoking. His remarks were thoughtful and considered, and to an extent at least, reflected not just his own personal views but those of his organisation. The comments made about auditing standards and about the loss of judgment are interesting in view, first, of the continuing emphasis of regulators and professional bodies on the promulgation of auditing standards that are at least ostensibly principles, rather than rules, based and, secondly, of the claims of recent external audit methodologies to initially orientate the audit around consideration of entity-specific risks. These remarks are also a useful reminder of the relative uselessness (or worse) of a checklist approach to the audit of management commentary.

Similar remarks were made by other interviewees. Another senior fund manager commented on the, in his view, lack of business experience even at senior levels in the audit profession:

*I think for a firm auditing these things it would be interesting to have proper businessmen to also have a view and then come to a collective audit view. I started in the late eighties – I’m 42 so I*
started my career in the last recession. There are audit partners of my age, and older, but there are probably plenty of people signing off audits who weren’t around in the last recession and certainly in the case of the senior managers, there will be a lot of work being done by people who have never seen a downturn. (FM9)

Again, this fund manager’s comments are interesting not just for his view on the expertise and experience available to professional firms but for the implications for assurance on management commentary implying that any arrangements purporting to engage with the more subjective and qualitative aspects of management commentary require to draw on thoughtful and experience-based judgments of skilful practitioners if such assurance is to enjoy the confidence of the investment community.

Two senior fund managers expressed reservations about contemporary high-level audit approaches based on the consideration of entity risks:

I’m not convinced from what I see that the risk-based approach is any better than a transaction based audit. I’m not sure some of the audit firms necessarily have as good a grasp of the underlying business because they’re taking a very much top down view as to what they think have been the factors which have been influencing companies’ business. (FM5)

One criticism that people make about modern audit practice is that it is too systems based and high level and does not incorporate enough detailed testing. I suspect we may have to go back to some more detailed testing. If that happens then of course audit costs will have to rise because it is more labour intensive and we will just have to accept that is the price we have got to pay to get better quality assurance. (FM3)
These individuals both had accounting backgrounds. As informed individuals representing major investors their views on contemporary audit methodologies are particularly interesting.

The other main strand of opinion expressed in the interviews related to the organisational arrangements for audit rather than the audit process per se.

Views of investors about the limitations of contemporary audit practices are juxtaposed with some negative opinion about the general way external auditing is arranged within capitalist economies and about external audit independence. A sell-side analyst expressed his view this way:

_I think that there is a degree of scepticism surrounding audit generally in the sense that it is a difficult model. You are being paid by the people you are auditing. There is a conflict of interest over who pays the auditor and in a perfect world there would be a completely different model where auditors were paid from a pool and assessed companies independently._ (SSA3)

A fund manager held an interesting view of how voluntary forensic services appeared to fill a gap that, in effect, was created by external audit inadequacies:

_There is a cottage industry of forensic accounting services – for example, people like CFRA and a few others – who investors on the buy side pay considerable amounts of money to in order to highlight accounting issues. You can see how that can be part of the auditing process …but investors so far are happy to have it as a separate industry working for the investment community rather than being morphed into the audit function working for the boards._ (FM10)
When it was suggested that auditors should be working for shareholders, rather than boards, this fund manager replied that:

*Maybe the investment community isn’t clearly convinced that auditors retained by boards are completely independent and act in the interests of shareholders because the industry ‘cross-checking’ company accounts does exist and is paid through completely separate channels and a completely separate relationship. In an ideal world, would it make more sense for an audit team to perform all this analysis with all access to the original records?... put it this way, it is quite striking that industry is happy to pay for these services that can act on publicly available information only. Their only advantage is their independence of the company auditor. That speaks volumes about some degree of scepticism with regards to auditor independence. (FM10)*

This fund manager later indicated that he had not really appreciated that auditors should be working for shareholders. His comments are suggestive of a possible latent demand for a more probing audit, perhaps partially focused upon management commentary. Nevertheless while significant reservations are held by some professional investors about the robustness of auditor independence, the views expressed were relatively moderate.

More extreme views were held by some private investors although these may not be representative of private investors as a whole:

*I rant and rail about the audit profession and I would love to see it freed from the trawl of management. Something government could do, would be to say to audit firms ‘you can’t audit a company for more than five years or whatever and there has to be some serious rotation’ ...and of course UK Plc would fight that to the death but that might make a difference.’ (PS2)*
Usefulness of external audit reports

Useful external audit engagement with management commentary presupposes that the consequent audit reports are of value to users. It was therefore considered to be appropriate to elicit user perceptions about the usefulness of existing audit reports. Another reason for investigating views on this issue is the recent APB initiative (APB, 2007) to revise audit reports. Both investor and non-investor questionnaire surveys, therefore, sought to identify perceptions as to the usefulness of contemporary audit reports. The results are shown in Table 6.2.

Table 6.2 Perceived usefulness of contemporary audit reports

<table>
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<tr>
<th>Panel A: Investors</th>
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<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
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<tr>
<td>Perceived usefulness of</td>
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<td>1.12</td>
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<td>audit reports¹</td>
<td>2.75</td>
<td>1.11</td>
<td>3.02</td>
<td>1.08</td>
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<th>Panel B: Non-investor stakeholders</th>
<th>Total</th>
<th>IP</th>
<th>AB</th>
<th>OS</th>
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<tbody>
<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
</tr>
<tr>
<td>Perceived usefulness of</td>
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<td>0.94</td>
<td>2.86</td>
<td>0.91</td>
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<tr>
<td>audit reports¹</td>
<td>3.16</td>
<td>1.02</td>
<td>2.94</td>
<td>0.75</td>
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</tbody>
</table>

Notes:
¹ No significant differences at 5% between mean scores.

Legend: 1 = Agree strongly 2 = Agree 3 = Neutral 4 = Disagree 5 = Disagree strongly

The mean scores for both the investor and non-investor groups is greater than 3 (3.09 and 3.04 respectively and may be characterised as mildly negative. There is some congruence between the responses to this question and those to the previous question on the audit process. The rank order of the mean responses of the various stakeholder groups...
is identical to that of the previous question and there is a similar pattern of inter-group differences. The mean scores for each group, however, are lower than those for the previous question in every case, suggesting that all stakeholder groups perceive audit reports more negatively than they do the audit process itself. There is also, as indicated by the standard deviation, a wider diversity of view on the usefulness of audit reports than there is on the robustness of the audit process and this is particularly the case for investors. While only six individuals, or about 2%, of all respondents to both surveys, scored audit reports as ‘very useful’, 37% of respondents to the investor questionnaire, and 24% of those to the non-investor version, assessed audit reports as either ‘not very useful’ or ‘useless’; 14% of the investor questionnaire responses to this question assessed audit reports as ‘useless’.

These results certainly suggest that there is a need for initiatives, such as that of the UK Auditing Practices Board (APB, 2007), to enhance the usefulness of audit reports. The interviews investigated views on audit reporting in more depth and confirmed the questionnaire results. Almost all professional investors stressed the limitations, or even uselessness, of existing audit reports. The following extract from an interview with a senior fund manager gives a measured and reflective view of the limitations of existing reports:

*What is actually being reported by the auditors to the shareholders tends to be a pro-forma, bland statement which doesn't actually say very much and in terms of the length of the report it covers about a good, full page of A4 size, fairly small print with lots of caveats and you'll probably find in the last paragraph in the bottom right hand corner there's something saying ‘yes the statements give a true and fair view’. But it's boilerplate and basically it does not matter how big or how small the company is or how extensive the audit has been or how costly the audit has been – at the end of the day, most companies get the same report. I'm not sure it's actually terribly helpful to anyone.* (FM5)
This fund manager acknowledged that existing audit reports might be more useful when these qualified the financial statements:

*It's quite interesting in the situations where the audit report is qualified to some degree; then you may perhaps see the impact of that in terms of how investors take a view as to the financial viability of the business; I've heard of one or two instances of that recently where audit firms have actually come up and questioned whether or not effectively the companies have the access to finance to allow them to continue in business. When that comes out that definitely does have an impact, so I think the audit report does have value in these circumstances. Generally, though, it would have greater value if it was less boilerplate in content. (FM5)*

Another fund manager, and a corporate governance specialist, reiterated these comments while pointing out that, in reality, the frequency of qualifications was rare:

*How useful are current external audit reports? Well, they are very formulaic. It is effectively a pass or fail – this gives a true and fair view – when do you ever see any qualifications? I know there is a kind of intermediate ground with matters of emphasis, and perhaps as we move into more difficult economic circumstances auditors will be a little more forthcoming on that, but I do see difficulties with this as far as the relationship with management is concerned. Auditors perhaps need to make it clear that the audit report isn’t a black or white, pass or fail – there are nuances. If they could somehow move to reflecting these, then that would be enormously helpful. (FM3)*

This is an interesting comment, emphasising the need for audit reports to reflect shades of grey rather than merely black or white. There
is also an implied difficulty in achieving useful audit reporting given the
closeness between auditors and corporate management. Another fund
manager emphasised the feelings of frustration felt about meaningless
audit reporting:

_The whole of the audit is pretty much invisible to us, you know_
— we see one page in the annual report and frankly the whole of
that page is boilerplate apart from the one sentence. We see a single
sentence which stands for a lot of work and frankly quite a lot of
money — we simply do not know what lies behind that one sentence
and therefore the profession is almost inviting us to worry about
things, because we can’t get a handle on anything more substantial.
Clearly current reporting isn’t doing the job for the users. It very
much seems to be safety first and protecting the profession — trying
to close the expectations gap and lots about what the audit doesn’t
do and less about what the audit does do — in a sense that is
another aspect of the concern I have about the profession losing
its confidence. But actually if the profession wants to demonstrate
the value that it adds and to justify itself to the world at large,
particularly to the shareholders who are paying the bills, talking
more about what the audit does do, and what the auditors have
done, rather than talking about what the audit is not, has got to
be the right way to go. From the ongoing debate about liability it
appears very clear that the Bannerman paragraph will stay in. We
sincerely hope that will be the only bit of boilerplate that stays in
and that we can move towards something that is more informative
and more useful. (FM2)

The use of ‘we’ reflects the fact that the views expressed are not just
the speaker’s own but those of his institution, one of the very largest
UK fund management institutions. These views were also shared by
private shareholders; one of them expressed his views perhaps rather
more informally than the professional investors but the underlying message is the same:

_I can’t honestly remember reading any of them because they seem to grow ever longer with stereotyped phrases that have been laid by the regulations. Everybody knows what they say, more or less, but it does always strike me as odd requiring people to certify great long lists of stuff, which are purely formal and are liable only to persuade everybody to ignore them._ (PS1)

Another private shareholder stated that:

_There is usually about three lines which are relevant and half a page that doesn’t really say much at all._ (PS3)

The adequacy of audit reports was addressed to a lesser extent in the non-investor interviews; the CFO expressed his view on the issue succinctly in stating that audit reports were becoming ‘longer and longer – and less and less informative probably’. (BU)

The only interviewee who expressed a positive view about the usefulness of existing audit reports was the insolvency practitioner who believed that audit reports had become more helpful. The general message on the issue of audit report usefulness, however, is clear and unambiguous. Audit reports are most definitely not perceived as useful by either investors or non-investors and these findings should sound a wake-up call to the profession. At the very least, the recent APB initiative (APB, 2007) to improve audit reporting has come none to soon. The following section of this chapter reports some of the suggestions made by research participants themselves to enhance audit reporting. Stakeholder views on this issue also suggest that it is vital that the benefits of any assurance, whatever its scope, of management commentary are not dissipated through meaningless reporting. This is
particularly the case given the potential for management commentary assurance to engage with subjective and judgmental matters. The relatively modest enthusiasm expressed for assurance on management commentary by some participants may be reflective of the anodyne nature of the concomitant audit reporting.

**Enhancing audit report usefulness**

Each questionnaire survey asked a further question on steps that might be taken to enhance confidence in audit reports. The possible mechanisms which respondents were asked to assess were identical in each questionnaire except that investors’ views were sought as to the usefulness of incorporating information in audit reports on alternative accounting treatments. In the interests of brevity, and because of its technical orientation, this question was omitted from the non-investor questionnaire. The results are shown in Table 6.3.

**Table 6.3 Perceived usefulness of possible mechanisms to enhance user confidence audit reports**

<table>
<thead>
<tr>
<th>Panel A: Investors</th>
<th>Total</th>
<th>FMA</th>
<th>FP</th>
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<tr>
<td></td>
<td>M</td>
<td>SD</td>
<td>M</td>
<td>SD</td>
</tr>
<tr>
<td>More reference to future risks and uncertainties. ¹,²,³</td>
<td>2.47</td>
<td>1.13</td>
<td>2.90</td>
<td>1.11</td>
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<td>Reference to audit issues of a judgmental or sensitive nature and their resolution.</td>
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<td>0.92</td>
<td>2.31</td>
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<tr>
<td>‘Company-specific’ commentary by the auditors on their work. ²,³</td>
<td>2.49</td>
<td>1.03</td>
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<td>Information on alternative accounting treatments.</td>
<td>2.24</td>
<td>0.96</td>
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</table>
Table 6.3 Perceived usefulness of possible mechanisms to enhance user confidence audit reports (Cont.)

<table>
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<tr>
<th>Panel B: Non-investor stakeholders</th>
<th>Total</th>
<th>IP</th>
<th>AB</th>
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<tr>
<td></td>
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<td>SD</td>
</tr>
<tr>
<td>More reference to future risks and uncertainties. 1</td>
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<td>Reference to audit issues of a judgmental or sensitive nature and their resolution.</td>
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<td>'Company-specific' commentary by the auditors on their work. 3</td>
<td>2.11</td>
<td>0.92</td>
<td>1.95</td>
<td>0.80</td>
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</table>

Notes:

1 Significant difference at 5% between mean scores for fund managers and analysts and those for other finance professionals.

2 Significant difference at 5% between mean scores for fund managers and analysts and those for private shareholders.

3 Significant difference at 5% between mean scores for investors and those for non-investor stakeholders.

Legend: 1 = Agree strongly  2 = Agree  3 = Neutral  4 = Disagree  5 = Disagree strongly

The results for both investor and non-investors indicate that these possibilities are all regarded quite positively by each user constituency. As far as the four possibilities put to the investor groups are concerned these were rated respectively, in the order they are presented in Panel A of Table 6.3, as ‘very useful’ or ‘useful’ by 62%, 80%, 60% and 72% of respondents. All these possibilities, other than that concerning the incorporation of information regarding alternative accounting treatments, were also put to non-investors and were scored as ‘very useful’ or ‘useful’ by, respectively, 77%, 83% and 73% of respondents. The option clearly most preferred by both investor and non-investors is the incorporation of references to specific audit issues of difficulty and how these were resolved, which was regarded by 80% (83%) of
investor (non-investor) respondents as ‘very useful’ or ‘useful’. This resonates with the more radical possibilities for enhancing audit reports highlighted by the APB initiative (APB, 2007) by, for example, aligning UK audit reports more with those issued in France. This suggests that revising audit reports along these lines would be well received by users. The results in Table 6.3, however, may suggest that other possibilities such as more reference to future risks and uncertainties and client-specific commentary by auditors on their work may also be worth exploring.

There are some inter-group differences on the issue of enhancing audit reports. Most notably, fund managers and investment analysts are less enthusiastic about the various possibilities offered in every case and their approval of each possibility was significantly less than either or both of the other two investor groups at the 5% level. There are various possible explanations for this. One is that fund managers and analysts are accustomed to carrying out their own, often very detailed, analyses on companies and have, therefore, confidence in their own judgments in this area juxtaposed with reservations as to what might be expected from auditors as far as these judgment calls are concerned. Another related explanation is that fund managers and analysts have a greater appreciation than other users of the difficulties involved in making judgments about risks and other financial statement complexities; they may therefore be less sanguine as to the abilities of external auditors in these areas. It is perhaps worth noting that as far as the non-investor groups are concerned, accountants in business were less positively inclined than other non-investors, significantly so at the 5% level in the case of ‘other stakeholders’, to the incorporation of information on future risks. Much the same point on appreciating the difficulties and complexities involved in effective risk analysis may apply to them as to fund managers and analysts.

One further related question on the usefulness of audit reporting on issues such as management competency and the adequacy of company infrastructures, was incorporated in the investor survey, as shown in Table 6.4.
Table 6.4  Perceived usefulness of audit reporting on management competency and company infrastructure

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<td>Reporting on issues such</td>
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<td>management competency and</td>
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<td>3.10</td>
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Notes:
1. Significant difference at 5% between mean scores for fund managers and analysts and those for other finance professionals.
2. Significant difference at 5% between mean scores for fund managers and analysts and those for private shareholders.

Legend: 1 = Agree strongly   2 = Agree   3 = Neutral  4 = Disagree  5 = Disagree strongly

At best, respondents can be regarded as mildly positive on the desirability of this proposal. While 51% of respondents from the three investor sub-groups thought that reporting by auditors on these issues would be ‘very-useful’ or ‘useful’, a large majority of the remaining respondents (34%) assessed the proposal as ‘not very useful’ or ‘useless’. It is consistent with the responses to the other questions on audit reporting that fund managers were less enthusiastic about this proposal than other investors. This may very well reflect this group’s perception of their own ability to assess corporate management and their view that this is likely to be more reliable than that of external auditors. Indeed, anecdotally, a principal benefit of one-to-one meetings between analysts or fund managers and corporate management is a view on management competence and integrity.

The usefulness of existing audit reports and how these might be enhanced was explored in greater depth in the interviews. It was clear from the interviews that there is a general appetite for audit reports to convey something of the subjectivities and judgments that are inherent
in corporate reporting and in the external audit. The fund management industry representative suggested that:

[The APB discussion document] was very good in terms of starting to advance the right sort of areas. There needs to be an agenda to move to more shades of grey. I think that there needs to be a general acceptance that if there is something in the report it is not necessarily a qualification. (IR)

This reflects the need for audit reports to include matters of uncertainty and that some minimum level of change is needed. Another fund manager expressed his preference for audit reports that would:

...provide a little bit of colour with the financial statements. It may be that there isn't anything to say in which case that's absolutely fine. But it may be that the auditors might report, for example, that they had discussions with management about whether they should mark-to-model or mark-to-market and that as described in note 26, or whatever, the company has adopted an approach with which we concur… or something of that nature. (FM1)

The accountant in business also suggested reporting auditor-management dialogue:

It probably wouldn't be in the audit report as it's currently structured but it might perhaps form a little section that says 'here are some of the discussion points that were raised between the auditors and management and the conclusions that we came to'. It's then open to any reader or user to make their own judgment as to whether those conclusions were valid or not. (BU)
These comments reflect an almost universal desire for more informative, and more company-specific, audit reports of this nature on the part of interviewees. One of the very few individuals who expressed reservations was a sell-side analyst whose rather negative perceptions on the issue may have reflected a belief that this would amount to a partial colonisation of analyst territory by auditors:

*I think you raise a big issue... which is that in areas where there is uncertainty there may be an argument for having some ranged or scenario based analysis. That could be applied to provisioning or whatever... I don’t know, I am just struggling about what the auditor is going to be able to meaningfully say that adds any value to what people are already assuming and also stays within their brief of providing an audit opinion as opposed to providing an opinion on future outlook or whatever.* (SSA1)

The consensus of opinion, however, was such that it is unsurprising that most interviewees viewed the more radical possibilities for audit reporting exposed by the recent APB discussion document (APB, 2007) positively. Interviewees were asked specifically about the possible reporting model highlighted in the APB document along the lines of French audit reports. Typical comments included:

*This [i.e. an example of a French audit report] is interesting in that what comes out on the second page is that they have made specific comments about accounting treatment – they've specifically made comments about goodwill, for example, and I find that interesting because it's specific to this company and what's happening in its divisions. That's a useful thing to highlight because it's the kind of information that otherwise, within in the UK, the analysts will have to go and find and highlight for us in our own internally generated research.* (FM4)
I think that this is immensely helpful and without knowing very much about the French system – I know it’s highly codified and that you can’t import it wholesale to England and Scotland – I think this is something that should be studied carefully. I know I would read this sort of thing. I like the direct reference to goodwill and examples of write down. I would endorse it in principle. I think you have to probably spend more time thinking about the details but, in general terms, this is extremely helpful. (FM3)

There was much other comment along the same lines. One fund manager believed innovation along these lines would be helpful but was cautious as to the eventual option which would actually be implemented by regulators:

Will they start moving down a much more value-added route? I suppose they put up some of the examples so they could be shot down and I think that it’s going to be the next stage that’s going to be really interesting. (FM8)

One fund manager was cautious about the dangers of replacing one form of boilerplate by another under the guise of more useful audit reporting.

I would say that the APB paper was a good one and it does move the debate forward internationally, not just in the UK. I don’t think the French report is better actually. It is more fulsome but it has become a form of boilerplate that is specific for the industry that the company is in rather than actually saying something useful about the individual company. How you can say something useful about the individual company without overstepping the mark is the challenge. (FM2)
Thus, another form of standard audit report – albeit one with more in the way of useful information – was not regarded as a panacea by all research participants – and a few proposed their own more radical solutions. One fund manager’s reflections partially mirrored proposals, as suggested in the academic literature, for ‘free-form’ audit reports:

*What I would ideally like to see is the audit firms being told to report on what they see as the key issues or findings of their audit. At the end of the day they might then say ‘irrespective of these findings we still believe these financial statement give a true and fair view’, but at least the report would be trying to give the reader an indication as to what has been carried out or the potential areas. There also has to be some indication of there having been some judgments, or the auditors have questioned judgments.* (FM5)

This fund manager, however, as well as interviewees generally, believed that at least some minimal reporting template was required. A private shareholder suggested putting the audit report very prominently near the beginning of the corporate report, almost in the nature of a warning:

*You could even put the statement on page one rather than on page 101. Put the auditors’ comments first and then have a caveat that everything after this is management comment so read it at your own risk.* (PS3)

Perhaps the most radical suggestion for enhanced audit reporting was the suggestion made by one fund manager that instead of being concentrated within one stand-alone report, auditors’ key comments should be interspersed throughout the corporate report at the relevant points. Auditors’ ‘qualifying’ comments would thus have a prominence
that they would otherwise lack. This comment was made initially in the context of assurance specifically on management commentary.

*Wherever your management commentary is, I guess that is where you want to be highlighting the areas of weakness. You want them in the same place.* (FM6)

This fund manager believed that the number of separate comments throughout the corporate report, which such an approach might entail, would increase auditors’ power as ‘people would question what was going on’. (FM6)

In summary, there is a requirement for more informative, and company-specific, audit reporting. There is an evident need for regulators such as the UK APB to continue to explore more radical options for change.

**Enhancing investor-auditor dialogue: other possibilities**

Since the results suggest a significant appetite for more informative audit reports, it was also considered appropriate to explore other channels by which dialogue with auditors might be enhanced. Interviewees were asked whether there might usefully be more shareholder-auditor engagement at corporate AGMs as well as any other dialogue-enhancing mechanisms. One fund manager stated that current investor-auditor contact is virtually non-existent:

*I see little, if any, contact between investors, shareholders and audit firms; the only time a shareholder will see an audit firm will be at an AGM and then the audit partner may or may not read out the audit opinion. So, we never have any contact with an audit firm unless as a result of some investment going horribly wrong*
and there was some action group being formed to potentially take legal action and that is so rare. (FM5)

Another fund manager expressed her views forcefully as to what she saw as fairly meaningless AGM ritual as far as auditors were concerned and made a thought provoking suggestion as to how this might be enhanced:

I always find it slightly amusing at AGMs to see the auditor stand up and read out what is already printed in the accounts word-for-word. What is the point in that? Wouldn’t it be much better if the auditor could actually explain at the AGM in more user-friendly ways what’s been going on with the company? We believe here at [name of institution] in attending AGMs if we can and to go along. I think that’s a very good idea because it shows that shareholders are interested in what’s happening with their business and, yes, it is an opportunity for the auditor on behalf of the shareholders to say something about the business. So there might be an opportunity for something worthwhile instead of what we have at the moment which is this recitation. (FM4)

These reflections on the way by which auditor involvement in AGMs might be enhanced resonate with the possibility of linking questioning auditors at AGMs to more useful audit reports. One fund manager pinpointed this potential linkage when he suggested that the facility to question auditors at AGMs:

...could be of interest but only if the auditor was actually saying something of interest in the audit report that you might actually wish to follow up on and explore more fully. (FM5)
The view that it would be appropriate for AGMs to feature some substantive auditor-shareholder engagement was shared by a private shareholder who stated that:

*For biggish companies it ought to be quite rational to think of an auditor being present at least and if anybody wants to ask any questions they will be available to at least take notes and get back to them if they can't answer them on the spot.* (PS1)

Some interviewees believed that the ability to question auditors at AGMs was unlikely to be of value because useful questions would not be asked. Another obstacle highlighted by interviewees was client confidentiality. This was not discussed in depth with interviewees but the possibility of how client confidentiality might be enhanced in these circumstances might be worth exploring by, for example, restricting shareholder AGM questions to issues already flagged up in more informative audit reports, perhaps with a partial focus on the management commentary. Some interviewees were positively disposed towards access to auditors through channels other than AGMs. One private shareholder believed that:

*It would be nice if shareholders were given unfettered access to auditors or at least if there was a schedule of access, window of opportunity or something.* (PS3)

Some professional investors were also at least tentatively, and in some cases, seriously, interested in this, although they also tended to be conscious of considerations of either auditor-client confidentiality or inside information. Comments included:
Maybe a results conference call could include a session with the auditors where questions could be asked. (FM10)

I think you’re getting into very dangerous territory here. I think that the furthest you can push it from information being generally available in terms of the audit report would be in proper form at the annual general meeting. (FM8)

One sell-side analyst, interestingly made a connection between facilitating this type of investor-auditor dialogue and the auditor opining on qualitative matters within management commentary which, this interviewee believed, were more properly the province of management:

*The auditors should ensure shareholders’ interests are taken care of so, why shouldn't there be dialogue? I suspect, though, when I think about it, practically the auditors would find such a dialogue very difficult because it would be hard for them to compartmentalise things that are legitimately an audit opinion away from things such as where the business is going, which are more properly the domain of management. So, it strikes me as in principle a good idea, but in practice quite hard to police.* (SSA1)

The union representative expressed an opinion to the effect that, at least in an ideal world, it would be desirable for external auditors to report to corporate stakeholders other than shareholders but also that ‘there is a widespread perception that auditors are not reporting to shareholders at all’. (TU)

Several interviewees reiterated the importance of re-establishing the historic relationship between shareholders and auditors but, because of the potential information and confidentiality problems already highlighted, believed that the proper forum for this was corporate audit committees.
The explicit restoration of the relationship between the auditor and the shareholders as a client ... is coming and we are starting to see that coming through but with a public company the communication should be with the audit committee chairman. The audit committee chair is a proxy for the audit committee and in the normal course of the day that would probably be the first line of dialogue. With auditors being reluctant to provide additional assurance it is in the gift of audit committees to be more expansive and effective in reporting. (FM1)

I think a number of investors would like to have more dialogue with the audit committee as to things like management letters and control weaknesses and I think all these things would enhance the quality of the audit in the eyes of investors. I don't think as it currently stands that they are necessarily getting the information, that it is giving them confidence. (IR)

Comments such as these resonate with the recently issued Guidelines for Enhanced Disclosure (GAID, 2009) issued by the Global Auditor Investor Dialogue. These represent an influential strand of investor opinion in favour of enhanced shareholder-auditor dialogue by means not dissimilar to those highlighted by several interviewees.

Summary

This chapter has examined more general points relevant to the contemporary audit and audit reporting and the following points can be made:

- Stakeholders are only mildly confident about the current external audit process. This general statement, however, covers a wide diversity of view and significant elements of all participant groups are not very confident, at best, in the external audit process. The key
fund manager and analyst group exhibit the lowest level of confidence in the audit process and cannot be regarded as even mildly positive as a constituency.

- Specific investor concerns include the business model commonly adopted by the auditing profession in terms of staff deployment on audits and a concern that the external audit continues to be process, rather than judgment, driven. Such considerations may affect the perceptions of professional investors as to the value of, seemingly, more robust approaches to assurance on management commentary itself. Other issues of concern to some investors, both professional and private, include the robustness of audit independence.

- A lack of confidence about the usefulness of current audit reports is exhibited by all the groups participating in the research. A tiny minority of research participants over all groups regard audit reports as ‘very useful’ and a significant proportion see them as not very useful or worse. The views of fund managers and analysts on this issue, as they are on the external audit process, are the most negative of the various participant groups. There is therefore an evident urgency for initiatives to enhance audit report usefulness. Initiatives such as the APB discussion document (APB, 2007) on enhancing the usefulness of audit reports should result in radical revision of existing audit reports rather than merely minor or cosmetic amendments if changes to audit reporting are to meet investor requirements.

- The previous recommendation is consistent with the opinion of research participants on possible mechanisms to enhance audit reports. Innovations such as incorporating information on future risks and uncertainties and commentary by auditors on their own work are certainly worthy of consideration by policy makers although there are also reservations by certain groups which should be assessed. Incorporating information within audit reports about subjective or sensitive audit issues is clearly regarded as a potentially useful innovation by all participant groups.
CONCLUSIONS AND RECOMMENDATIONS

Introduction

This report has a tripartite focus: stakeholder perceptions on management commentary; the possible provision of external assurance on management commentary; and more general issues concerning perceptions concerning the efficacy and value of external audit and external audit reporting. This chapter summarises the research findings in each of the three principal areas of investigation. The chapter concludes by reflecting on these more general implications of the research for policy makers and regulators and for the future of the external audit. Possible areas for future consideration by researchers are also addressed.

Stakeholder perceptions on management commentary

In order to contextualise the principal research findings more usefully, information about research participants’ knowledge about corporate reporting and about relevant regulatory developments was elicited where appropriate. A minority of respondents to the investor questionnaire survey described themselves as having a good, or better, knowledge of the IASB discussion document on management commentary. This applied almost as much to those claiming good knowledge of corporate reporting as to those who indicated that their knowledge of corporate reporting was less extensive.

Investors agreed generally that future corporate reporting would increasingly include information of a narrative character. While non-investors were not asked their opinion on this issue they were asked a related question as to their use of the narrative elements of corporate
reports; all three groups of non-investor stakeholders indicated that the narrative sections of corporate reports were important to them.

Both investors and non-investors indicated that management commentary was important when assessing corporate dimensions such as key resources, risks and relationships, past results, future prospects and performance measures and indicators. At the same time, there was recognition that information on many of these attributes was vulnerable to management ‘spin’ and distortion; this suggests a need for some external assurance in order for users – perhaps, most especially, non-sophisticated investors and non-investors – to enjoy reasonable confidence in corporate management commentaries. The use of ‘boilerplate language’ and management ‘spin’ are regarded as particularly important factors in potentially reducing management commentary usefulness.

Private shareholders appear to place more emphasis on management commentary than any other participant group, whether investor or non-investor. As far as investors are concerned, fund managers and analysts place rather less emphasis on management commentary than do other investors. This most probably reflects the greater variety of information sources at their disposal. Analysts, in particular, most obviously on the sell-side, appear to have little use for management commentary or, indeed, for annual corporate reports generally.

While there are a variety of perspectives on the regulatory approach that should be adopted in respect of management commentary structure and content, the consensus of investor opinion appears to be in favour of a light touch approach. Non-investors tend to be more in favour of more robust regulatory approaches. On balance, however, the most favoured approach appears to be one whereby the IASB, or other regulatory agencies as appropriate, mandated a template for structure and content which nevertheless left room for some exercise of discretion and ‘corporate house style’.
Conclusions and Recommendations

In summary, users generally perceive management commentary as useful although the evidence suggests that various factors are perceived to reduce that usefulness. The somewhat contradictory factors of ‘boilerplate’ wording and excessive management ‘spin’ appear to be particularly critical. While user perceptions on the need for assurance on management commentary were investigated separately and are summarised in the following section, stakeholder views on whether or not the content and structure of the management commentary itself should be regulated, and to what extent, provide some rationale for adopting an assurance model, which, while robust, is also tolerant of a degree of corporate individuality.

Provision of external assurance on management commentary

The issue of whether or not assurance on the management commentary should be provided was examined explicitly since it was the central concern of the research. There were two specific research questions relating to assurance. The issues arising from each are considered here sequentially although there is a degree of overlap between the two questions.

There is a reasonably strong view over both investor and non-investor constituencies that it is desirable to provide some degree of external assurance on management commentary. This view appears to be held slightly more strongly by non-investors. As far as investors are concerned, fund managers and analysts generally appear to be significantly less positive about providing assurance on management commentary than the other investor groups. The rather less enthusiastic perspective of professional investors reflects their desire to not constrain corporate managements’ discretion to tell a ‘story’ in their own way; in some cases, too, a relative indifference to extending assurance to management commentary appeared to reflect modest views of the value
of the existing external audit function. Over all respondent groups there is a significant degree of diversity of view.

Those research participants who were most positive about assurance on management commentary cited factors such as apparent inconsistencies between narrative statements and the hard data currently subject to audit as important influences in coming to this view. Those in favour of assurance on management commentary also argued for the need for auditors to curb excessive optimism in directors’ statements and to encourage directors to be more transparent in the information provided. Some stakeholders who did not support auditor involvement argued that auditors would not be able to report meaningfully on director statements because they lacked the resources to challenge directors in subjective areas such as strategy, risk management and future prospects. This view appears to be grounded in perceptions of the general limitations and weaknesses of the audit function, as it presently exists, rather than in a lack of appetite for assurance on management commentary per se.

It was acknowledged by some of the fund managers and analysts who did not regard assurance on management commentary as important, that while they themselves were able to form an opinion on the trustworthiness of management commentary from other evidence available to them, such evidence was not available to small investors or non-investors, and for them, assurance might well provide comfort.

There is recognition of the different challenges presented by different types of management commentary content; the obvious dichotomy is that between ‘harder’ quantitative, most obviously, financial, information and ‘softer’ qualitative content. Thus both investors and non-investors place relatively greater emphasis on assurance of more obviously ‘verifiable’ components of management commentary such as ‘past results’ and ‘key resources, risks and indicators’. Views on auditors’ ability to provide, or the desirability of, assurance on ‘softer’ components of management commentary, such as ‘future prospects’, are less positive. On softer information, there were some suggestions that
Conclusions and Recommendations

Auditors might usefully report in ‘softer’ terms; for example, whether or not the information was ‘reasonable’ or ‘not unrealistic’ in the light of information known at the time. This might provide valuable assurance to users who are unable to access the less public reports and briefings which might be available to professional investors. There is perhaps some, although not general, concern that such reporting might create potential audit liability problems and it may be desirable to develop safe harbours for both directors and auditors to offer protection against litigation for statements made in good faith that subsequently turn out to be incorrect.

There is a widespread view generally, therefore, that some external assurance on management commentary is desirable. More specifically, the strength and nature of this opinion reflects individual user constituencies and particular categories of management commentary content.

Extent and depth of assurance on management commentary

The research specifically sought to elicit opinion only from investors as to the most appropriate form of assurance that might be applied to management commentary. This was because a meaningful appreciation of this issue arguably requires a relatively significant degree of technical knowledge. In general, the more robust ‘content’ approach to assurance is generally seen as more appropriate for the more factual management commentary content; similarly the ‘lighter-touch’ approaches – ‘process’ or ‘consistency’ – for more subjective or qualitative content. There appears to be widespread agreement, even among those unconvinced by the need for assurance, that as a minimum level of involvement, auditors can at least be expected to report on the consistency of management commentary with the financial statements.

There are some apparent differences between the three investor groups that were the focus of the present research as to the preferred form
of assurance. The fund manager and analyst group, in general, prefer a ‘consistency’ approach and this is congruent with their generally less enthusiastic stance, relative to the other investor groups, on the need for assurance on management commentary generally. By way of contrast, other finance professionals are generally most favourably disposed to a ‘process’ form of assurance.

However as far as those research participants, especially fund managers and analysts, who were interviewed, are concerned, there is little enthusiasm for reporting on the processes involved in producing the information. Some research participants suggested that there was such a variety of possible approaches that auditor comment was not likely to be meaningful. Another perception which appears to be influential in this respect is that it is not processes that determine the truth or fairness of management commentary, but the quality of the people writing the report – something that is beyond process.

There are various views regarding assurance on content. The most general perception is that historic, factual content can be verified but that statements of risks and forecasts for the future are less verifiable. Some investors, however, believe that a robust approach to assurance on future information is possible. An example of a more subjective content element highlighted by the research in this regard is business risk. There is a suggestion that audit work and concomitant liaison with company directors before the production of the management commentary, may help to moderate excessive optimism and the omission or defective evaluation of significant risks. However, it was argued that auditor involvement in this area would tend to be ad hoc rather than comprehensive in nature and that any opinion could not be expressed in true and fair view terms. The need for a holistic approach to corporate reporting and the related assurance was emphasised. At present there may be confusion on the part of some stakeholders as to which sections of annual corporate reports are audited. While there is a view that audit firms should be able to extend the scope of their work to management
commentary with relatively little adaptation, there is some suggestion that the ‘process’ driven nature of some auditing and the prevalence of inexperienced audit staff are obstacles to this.

As far as the most appropriate vehicle for communicating assurance on management commentary to users is concerned, the preference over all investor groups appears to be that this should be communicated within the standard audit report on the financial statements rather than becoming the subject of a separate stand-alone report. More radical views held by individuals such as the provision of assurance ‘statements’ on specific parts of the corporate report or the interspersion of auditor and corporate report content may be worthy of consideration as possible ways towards providing more precise linkages between assurance statements and the subject matter that is the subject of assurance.

In summarising the results relating to assurance on the management commentary, there is a broad consensus that there should at least be some minimal level of external assurance. Beyond this, there is a rich tapestry of differing views; some of these are clearly held by only a small minority. Nevertheless, these, as well as more widely held opinions are worth discussing with external auditors as different approaches to implementing assurance are explored. Some stakeholder perceptions on management commentary assurance reflect perceptions about the robustness of existing external audit arrangements, processes and reporting more generally. These are explored in the next section.

**General issues of audit and audit reporting**

The final research objective deals with more general issues, stakeholder perceptions about the external audit process and views about present audit reporting. The results relating to the two research questions covering this objective are summarised sequentially in this section.

Generally, both investors and non-investors are only mildly confident about the robustness of the current external audit process. This
general consensus, however, masks a wide diversity of view and significant elements of all stakeholder constituencies appear to be unconfident in the external audit process. The key fund manager and analyst group exhibits the lowest level of confidence in the audit process and cannot be regarded as even mildly positive as a constituency.

In this context, specific investor concerns include the business model commonly adopted by the auditing profession in terms of the staff mix commonly applied on audits, with an emphasis on the employment of inexperienced, albeit often very academically able, individuals, and a concern that the external audit continues to be process, rather than judgment, driven. These factors may not be mutually exclusive – for example, process-driven, rather than judgment-centred, external audits may be more reassuring to audit firms operating in a litigious environment whose business models are grounded in the employment of inexperienced staff.

Such issues may also have implications for investor views about the provision of assurance on the management commentary and there is some evidence from the project that suggests this. For example, without overstating the possible ‘knock-on’ effects, the perceptions of professional investors as to the value of more ‘robust’ approaches to assurance on management commentary may be coloured by these considerations. Other issues of concern to some investors, both professional and retail, include the robustness of auditor independence.

While there appears to be a wide diversity of view among users on the audit process, this is much less so with the final research question that was investigated. A clear lack of confidence about the usefulness of current audit reports is exhibited by all the groups participating in the research. A tiny minority of research participants over all groups regard audit reports as ‘very useful’ while a significant proportion see them as not very useful or worse. The views of fund managers and analysts on this issue are the most negative of the various stakeholder groups who participated in the research.
There is evidence of a widespread desire for audit reports to assume a more useful character. Innovations such as incorporating information regarding future risks and uncertainties, and commentary by auditors on their own work, within audit reports might be considered by policy makers although there are also reservations on these issues held by some users which require careful consideration. Incorporating information within audit reports about subjective or sensitive audit issues would clearly be regarded as useful by all participant groups. There are suggestions that auditors might summarise what they see as the key issues or findings arising from audits within reports. Some users believe that audit reports would be improved by communicating more of the subtle nuances inherent in audits in shades of ‘grey’ rather than simply in terms of ‘black’ and ‘white’.

There is, then, an evident demand for initiatives to enhance the usefulness of audit reports and the results from this research question invite consideration by the audit profession. Initiatives to improve audit reporting may have to go further than the relatively modest amendments presently proposed in discussion documents such as that of the UK Auditing Practices Board (2007) if they are to satisfy the requirements of users.

**Wider issues and implications**

Demand for more useful information to be communicated within audit reports is clear evidence of a desire for improved communication between external auditors and investors. A more useful model for external audit reports is the most obvious way of satisfying the need for improved investor-user dialogue but other possibilities were proposed by users, particularly investors, who participated in the research including, perhaps most forcefully, a role for audit committees as a conduit for investor-auditor dialogue. Other possibilities attracting some support
include the provision of some facility for meaningful auditor-shareholder
dialogue at corporate annual general meetings.

The desire for meaningful investor-auditor dialogue might be
expressed as a desire to reinstate the historic shareholder-auditor link.
Such sentiments, however, appear to sound a note of discord with at least
some sections of the audit profession. A recent article in the accounting
trade press (Sukhraj, 2008) highlighted senior figures within the major
accounting firms giving voice to views such as that it was companies’
responsibility to provide ‘meaningful information’ to investors and that
‘the danger with auditors putting narratives in audit reports is that these
comments could be misunderstood’. The results of the present research
provide a different perspective on this issue.

Interestingly, a link was made by some investors who participated
in the present research between any drive to enhance auditor-investor
communication and the provision of assurance on more qualitative
corporate report dimensions such as management commentary. Thus,
these final research questions on perceptions of the audit process and
audit reports have resonance with the research question on management
commentary assurance that constitutes the core of the present project.
The issues are not mutually exclusive.

In some cases, the hardly radical notion that auditors should act
to serve investors seemed to come as almost novel to some of them.
These themes highlighted by the research echo a call sometime ago
in the academic literature (Hatherly, 2003) for auditors to ‘add value’
suggests that one way by which auditors could add value in this way is
by, in effect, writing their own ‘management commentary’ on companies.

In this way, the issues raised by the present research go beyond the
immediate questions concerning the management commentary to the
more fundamental question of the future shape of the external audit
function in twenty-first century capitalist societies (see also Fraser and
Pong, 2009). What sort of external audit function do investors, other
stakeholders and society wish? Can and will the external audit profession respond to user concerns in a meaningful way which adds value to investors and, if appropriate, to other users?

These wider concerns are particularly timely. While discussion of the external audit role in the current crisis has been relatively muted, questions are already being asked by prominent public figures, for example the former Conservative chancellor Nigel Lawson, (Hinks, 2009), about the contribution of auditors to recent corporate events. Such connections were made in less public fashion by participants in the present research; pointing out, for example, that there was an evident need for the audit to have more of a focus on business risks. This is ironic given the arguable retreat by the audit profession from ‘business risk auditing’ post-Enron. The fallout from the present economic and financial crisis may encourage government, regulators and significant stakeholders to be much more receptive to more radical solutions than at any time in the recent past. It may be timely for the audit profession to consider with urgency how its economic and societal contribution might be enhanced. Otherwise it is not inconceivable that rather than the issue of the day being one of how to make audit more useful the fundamental issue will be one of whether or not external audit in its present incarnation is useful.

**Overall summary and policy recommendations**

In brief, management commentary is regarded as valuable and it is anticipated that its value to users will increase. There is significant, although not overwhelming, demand for some external assurance on the management commentary. These results are juxtaposed with user perceptions of an external audit process which is only of moderate value in some cases and of external audit reports that are of very little value. There is a need for auditors to improve communication with investors and other stakeholders by more meaningful audit reports and
also possibly by other means. Whether this improved communication should include assurance on management commentary, and if so, to what extent, is a matter requiring further consideration and exploration with external auditors. This is important given that the current available evidence suggests that the prevailing attitude of the audit profession on the matter is a cautious one.

There is a clear need for policy initiatives to ensure that audit reports are more useful to users and to ensure that there are adequate conduits for meaningful dialogue between auditors and shareholders and other corporate report users. While the UK Auditing Practices Board has taken some tentative steps towards making audit reports more informative (APB, 2007) the research demonstrates a need for more radical policies. As a matter of routine, audit reports require a much greater focus on information, for example in regard to risks, uncertainties and audit findings, which relate specifically to the audited entity. Similarly, there is a need for policies focused on the reinstatement, in substance, of the legal relationship between auditors and shareholders.

It is not clear as to how this link might be most usefully reinforced and there are a variety of views; further research is therefore apposite in order to determine detailed appropriate policies on this issue. Other research findings require further research, particularly through exploration with representatives of the audit profession, before the broad outlines of policy initiatives are formulated. Such research should explore whether auditors are able and willing to provide assurance on management commentary, and if so, what level and scope of assurance is likely to be offered. The views of auditors on these issues are currently being investigated in a second stage of this project. There is a further opportunity, however, for such research to go beyond these immediate issues and to explore how the external audit generally might be enhanced so as to ‘add value’ to those who rely on it.
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Meeting the Needs? User Views on External Assurance and Management Commentary

The recent financial crisis has again brought to the fore questions surrounding both the scope and quality of the external audit. In conjunction with this, narrative reporting or management commentary continues to grow in importance in the annual reports of companies and therefore the question as to whether and, if so, how assurance should be provided on such information is fundamental.

This project investigates views on the value and importance of management commentary and whether there is a demand by corporate report users for external assurance on management commentary. Users’ opinions about these issues also naturally turns attention to more general views on the scope and value of the current statutory audit, looking particularly at the level of confidence in the present external audit process, the perceived usefulness of current external audit reports and views as to how the usefulness of audit reports might be enhanced. These more general findings are therefore also reported in this study.

This study is based on a questionnaire survey of professional and private investors, finance professionals and other users. This was supplemented by interviews to explore the issues in greater depth.

A second stage of this project is currently in progress – this will investigate whether auditors are able and willing to provide assurance on management commentary.

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