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Meeting the needs?

User views on external assurance and management commentary

Ian Fraser and William Henry

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Research summary report

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User views on external assurance and management commentary

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

This research summary report drafted by two of the authors of the full report provides a good summary of the project and its findings. The full report can be downloaded free of charge at www.icas.org.uk/fraser-users. 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

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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.

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1. Introduction

This short publication is intended to provide a readily accessible and non-technical summary of the first stage of a major research project supported by The Institute of Chartered Accountants (ICAS) and the Scottish Accountancy Trust for Education and Research (SATER) on the future of external assurance. Those interested can obtain a much fuller account from the ICAS monograph (Fraser *et al.*, 2010) on the research which is being published concurrently with this summary (download at: www.icas.org.uk/fraser-users). The two principal issues with which the project is concerned are: first, the provision of external assurance on management commentary and other narrative corporate reports and, second, perceptions regarding the usefulness of audit reports and the robustness of contemporary external assurance. This report covers the views of professional and private investors, as well as other users, on the issues; the second stage, presently in progress, deals with those of auditors; a possible third stage will investigate the perspectives of key corporate players, both executives and non-executives.

2. Background

The specific motivation for the research is the gradually increasing importance of narrative disclosures in the context of annual corporate reporting, both in the UK and internationally. Important examples include the US Management Discussion and Analysis (MD&A), the UK Operating and Financial Review (OFR) and, internationally, the Management Commentary project of the International Accounting Standards Board (IASB) which has resulted in an important discussion paper (IASB, 2005) and, more recently, in an exposure draft of an International Financial Reporting Standard (IFRS), (IASB, 2009). These developments suggest that narratives in annual corporate reports will assume a still greater degree of significance and the appearance of an IFRS on management commentary appears probable. This raises an important question: Is there a demand for external assurance on management commentary, and other similar reports, on the part of corporate report users? This is the primary motivation for the research.

Views on whether assurance on management commentary is desirable may hinge partially on more general perceptions as to the robustness of the contemporary external audit function and the value of audit reports. Opinions on the underlying strength of the audit process, for example, are likely to influence views on auditors' ability to provide assurance on management commentary, which is often likely to have a high proportion of subjective or problematic content. Similarly, if audit reports have only limited benefit for users then this requires resolution before the scope of audit reporting can be usefully extended. The research, therefore, also explores these broader issues.

Recent economic and financial events give added relevance to the research. While the role of the audit profession in the recent financial crisis has not yet been the subject of detailed analysis in either the professional and business press or in academic literature, it seems probable that, before long, there will be again be cries of 'where were the auditors'? The drama which reached a climax in the autumn of 2008, revealing ever-more evidence of corporate weakness and systemic failure, has created an opportunity, therefore, to investigate views on audit and corporate reporting at a critical time economically. Criticisms, arguably often inappropriate, of fair value accounting and of the opaqueness which is arguably inherent in some aspects of IFRS-based corporate reporting suggest that there may be demand for versions of corporate reporting which are more transparent and accessible. Additionally, sober reflection on the way capitalism works has provided an opportunity for serious debate about how a reformed external audit function could contribute to market economy stability. While the research does not address these broader issues specifically, they constitute an additional dimension of relevance.

3. Objectives and research approach

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

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

(2) the need for external assurance on management commentary and the extent and scope of the assurance that should be provided; and

(3) the extent of confidence in the present external audit process, the perceived usefulness of current audit reports and views as to how that usefulness might be enhanced.

There were two sequential stages to the research carried out. First, two questionnaire surveys were carried out. The first of these was administered to professional and private investors and to other finance professionals (206 respondents – response rate 12.1%). The second questionnaire, an abbreviated version of the first, was sent to representatives of various non-investor users. (82 respondents – response rate 11.6%). Second, twenty-six semi-structured interviews were carried out which explored in greater depth issues which had either been included in the questionnaire surveys or highlighted in the questionnaire responses. Twenty of the interviews were carried out with investors and six with non-investors.

Prior to the primary research, a literature review was carried out to establish the existing state of knowledge on the issues and to inform the preparation of the questionnaire surveys and, in due course, the interview agendas. The following section summarises the research background in terms of both strategic legislative and regulatory developments and key literature. References to the research literature, as opposed to some regulatory material, are not given here for the most part in the interests of brevity of exposition; interested readers are referred to Fraser *et al.* (2010).

4. Literature review and regulatory background

Corporate reporting

Over the past decade, various researchers have concluded that corporate reporting to the financial markets is likely to take on increasingly a *narrative* as opposed to a *numerical* character. One reason for this is that contemporary reporting entities have an increasing proportion of their asset base in intangibles such as brands, relationships and expert-knowledge, which are 'off-balance sheet' and which, therefore, require narrative disclosure to enable users to understand key business dimensions. Certainly within western economies such as the UK, the standard manufacturing company, with assets mainly consisting of tangibles such as plant and machinery, is partly becoming a past phenomenon. In addition, contemporary organisations operate in high risk environments characterised by political, economic and technological change. Purely *numerical* or *financial* reporting is likely to capture an increasingly small proportion of the available information for such entities.

During the 1980s, the US Management Discussion and Analysis (MD&A) developed into an evaluative document to meet user demands for better information although there were mixed views on the document's usefulness. In the UK, the ASB proposed the Operating and Financial Review (OFR) as a voluntary document in order to encourage open and flexible reporting by companies on their operations, finances and shareholder return and value. Research conducted in the 1990s found that UK reports were more flexible and offered more voluntary and forward-looking information than their US counterparts and although misgivings were expressed about the voluntary approach, preparers did not wish it to be as prescriptive as the US MD&A.

Since the advent of the OFR the extent of UK narrative reporting has grown impressively. The proportion of UK listed companies' annual reports consisting of narrative reporting had increased to over 70% for the top 350 companies by 2007. However, there was wide variation in the form and content of the information provided. There was overlap between the OFR and corporate social responsibility reports and disclosures in respect of future prospects were perceived to be 'opaque and non-specific,' although 75% of OFRs did mention risk in some way. Proposals for a statutory UK OFR were unexpectedly replaced in November 2005 by a lesser requirement for an 'Enhanced Business Review'. Concern has been expressed that abandoning the more onerous statutory OFR may have impacted negatively on directors' willingness to engage in dialogue with shareholders through enhanced narrative reporting.

In 2005 the IASB issued its discussion paper *Management Commentary* (IASB, 2005) which proposed that entities should disclose information on the nature of the business, objectives and strategies, key resources, risks and relationships, results and prospects and performance measures and indicators. At present there is a wide variation in corporate disclosures in these areas; this is unsurprising given the voluntary nature of management commentary. There is evidence, however, that users envisage a need for narrative reports; this bodes well for the future of management commentary which has very recently become the subject of an IASB exposure draft (IASB, 2009).

Assurance

Developments in narrative reporting highlight the possible need for associated independent assurance. *Management Commentary* (IASB, 2005) itself suggests that the issue of assurance on management commentary reporting invites investigation. The last twenty years have seen calls for research focused on users' evolving assurance needs. Because of the blurring between the content of management commentary, and that contained elsewhere in annual reports, assurance on management commentary would necessitate a clearer delineation of audited and unaudited material. In addition, external assurance on management commentary would require clear prescription of required management commentary content to prevent director manipulation.

Concerns, however, have been expressed about the feasibility of providing assurance on some elements of management commentary, for example, future forecasts and risk assessments, and three possible forms of assurance have been suggested:

- *Consistency*: whether the information in management commentary is consistent with that given in the entity's financial statements and other information that has come to the attention of the assurance provider.

- *Process*: whether procedures followed in producing management commentary are designed to ensure that the content is truly and fairly stated.
- *Content*: whether the content of management commentary is truly and fairly stated.

The third option may be problematic since much management commentary content constitutes an expression of opinion rather than of fact; completeness checks may also be difficult to execute. The question of whether reporting on management commentary should be couched in positive, negative or exceptional terms is a further issue. It may be that statements by directors, for example, to the effect that forward-looking information should be treated cautiously, would enable helpful assurance to be offered without exposing auditors to undue litigation risk.

For the most part, the attitude of the UK auditing profession to assurance on management commentary has been extremely cautious regarding the scope and extent of assurance, with the proposed assurance being restricted for the most part to consistency reviews:

> *The type of work required to make any judgment 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 a much wider set of inputs to the process... some of which may lie outside the auditors' competence to comment upon...* (ICAS, 2004)

Guidance from the International Auditing and Assurance Standards Board (IAASB) also reflects a cautious attitude and the recently revised ISA 720 *The Auditor's Responsibility in relation to Other Information in Documents Containing Audited Financial Statements* (IAASB, 2009) continues to mandate 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. In the US, however, requirements for assurance on MD&A go beyond what is currently required by the IAASB, although these are restricted to commenting on the present and past, with a much more tentative approach taken to future information.

The limited prior research, in the US and the UK, suggests significant demand for some assurance on non-financial and forward-looking information. UK users have indicated a preference for a 'true and fair' opinion on management commentary, arguing that bland statements as to consistency with the financial statements are inadequate. This suggests a need for assurance on management commentary content.

Submissions to the IASB on *Management Commentary* (IASB, 2005) demonstrate a wide variety of view. The most popular argument appears to be for consistency reviews with some negative views articulated on the subjectivity of much management commentary content and the cost of assurance. There is, however, evidence that some users, including non-investors such as environmental groups, would expect more robust assurance on management commentary than that of consistency reviews; there may therefore be a potential expectations gap in terms of the assurance desired by users and that which may be offered by the auditing profession or other providers.

While the audit profession appears reticent about providing assurance on management commentary, the adoption of audit approaches grounded in business risk by the large audit firms in the 1990s may provide a platform for auditor engagement with the risk dimension of management commentary content. Although there has been something of a retreat from business risk auditing, its introduction was instrumental in the creation of a new series of international auditing standards with a professed business risk orientation; these may provide some basis for substantive assurance on management commentary.

At the same time, there are concerns that contemporary audits are too focused on checking numbers created by increasingly complex IFRS-based financial reporting – at the expense of auditing the business. Assurance on management commentary might help to link the statutory audit with greater business understanding and improve audit quality. Anecdotally, there appears to be a view that some recent audit failures have resulted from a lack of business understanding. Calls for reformation of external auditing have emerged, not only from academics, but from the profession itself. These calls have suggested that the profession should review its societal obligations and provide assurance that goes beyond purely accounting information. Unwillingness to engage with management commentary may result in other providers supplying the assurance required by stakeholders.

Calls for audit reporting which deals with management commentary lead naturally to consideration of the value of audit reports more generally, with suggestions being made that these should provide more company-specific information. This in turn prompts consideration of the value of the audit product itself. There is a long-standing 'critical' accounting literature which has questioned the professionalism and independence of the audit profession and recent writers have directed attention to the role played (or not) by external auditors in the recent global financial crisis and, more specifically, in the failures within the corporate financial sector. As a result, the research deals with user perceptions of the value of present audit reports and of the robustness of the audit process.

In summary, the key issues emerging from the prior literature and regulatory developments are:

- Corporate reporting is likely to increasingly take on a narrative, as opposed to a numerical, character.
- Developments in narrative reporting have highlighted a possible need for assurance on management commentary, but there are concerns about how easy it may be to provide this for some information categories; there are also various opinions on the assurance that should be provided. Three possible forms have been suggested: *consistency*, *process* and *content*.
- External auditors appear cautious about providing assurance on management commentary but fairly recent audit methodologies grounded in business risk may provide a platform for developing management commentary assurance.
- Considering assurance on management commentary prompts reflection on more general issues regarding the value of contemporary audit reports and the audit itself.

The following sections of this summary deal sequentially with the findings relating to each of the three principal research objectives.

5. Stakeholder perceptions on management commentary

Corporate reporting and management commentary

To put the research in context, research participants were asked about their knowledge of management commentary and corporate reporting generally. A minority of investors responding to the questionnaire claimed a good or better knowledge of the IASB discussion document on management commentary. This applied almost as much to those claiming good levels of knowledge of corporate reporting as to those who indicated less familiarity. Investors agreed generally that future corporate reporting would increasingly incorporate narrative information. Non-investors were asked a similar question about their use of the narrative elements of corporate reports. The responses from all non-investor groups surveyed, indicated that the narrative sections of corporate reports were important to them.

In the interviews, further insights were gained as to how users envisaged management commentary being used. Themes emerging included the desirability of a holistic approach to reporting and the usefulness of management commentary both in clarifying aspects of, arguably, increasingly opaque IFRS-based financial statements and in acting as an entry point for more detailed analysis – by facilitating dialogue between users and company directors on business prospects, risks and challenges and the benchmarks against which corporate performance might be assessed. One fund manager observed:

> *I think... that companies will feel increasingly a greater obligation to tell their own story and to get their message across clearly. 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 perceptions of the business that they want to explain to users.*

Professional investors, in particular, tended to emphasise the historic aspects of management commentary and its ability to shed light on the financial statements. Forecasts, whilst recognised as important, were seen as often bland and nebulous; being constrained by confidentiality and litigation concerns. Corporate reports were often perceived as lacking in serious discussion of future risks. Social and environmental reporting was highlighted by some interviewees; both fund managers and non-investors. It was stressed, however, that there was uncertainty about how best to report environmental issues and that much environmental reporting was selective and not very useful.

Some investors, most especially analysts on the sell-side, have very limited use for management commentary and for corporate reports generally; relying more on interim announcements, conference calls, private briefings and other privileged information. All groups of research participants, however, regarded management commentary as important in understanding corporate dimensions such as key resources, risks and relationships, past results, future prospects and performance indicators. At the same time, there was recognition that information on many of these attributes was vulnerable to management distortion. While private shareholders generally appeared to place more emphasis on management commentary than other stakeholders, one professional investor stated that:

> *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 reported results but it can also give an indication of the risks of the business, how it is progressing and potential future developments. What investors want is more colour and more company-specific information on what has happened and on prospects for the business.*

Barriers to management commentary usefulness

Various factors were highlighted as significant in limiting management commentary usefulness. Most mentioned were 'boilerplate language' and misleading management 'spin'. Several interviewees expressed frustration at the blandness of much management commentary content, although recognising the inevitability of companies seeking to present themselves favourably and director concerns about being accountable for unrealised predictions. The key issues for users were to make sure that narrative comments were interpreted with an appropriate level of scepticism and to confirm that the message given in the management commentary was consistent with the numbers. This was brought out by one fund manager's comment:

> *...management commentary in accounts is sometimes used as a way for management to get across particular messages that they want shareholders to have, either about their strategy, an acquisition they've made or a policy they have in place and very often what you find is that it's only when you get down to the numbers that you find out whether the commentary ties in accurately with the numbers behind it.*

This statement, representing the views of many investors, may indicate the need for reasonably robust assurance in order to ensure confidence in management commentary reporting.

Structure of management commentary: prescription or corporate discretion?

Generally speaking, users appear likely to welcome the IASB establishing at least some minimal regulatory framework for management commentary but there are concerns that too prescriptive an approach would lead to more box-ticking and boilerplate. Most interviewees favoured 'light-touch' regulation to give directors a free hand in 'telling the story' of companies in terms of performance, future prospects and risks. It was argued, however, that total laissez-faire was inappropriate and that a broad framework required to be established by the IASB supplemented by examples of good practice.

Other users stated their preference for a more prescriptive approach, fearing 'cherry-picking' by directors. Thus, while there was a variety of view within the broad 'business' constituency of users, the prevalent preference appears to be for 'light-touch' regulation.

6. Enhancing management commentary usefulness: assurance

Assurance on management commentary

Both questionnaires asked users to score the importance of assurance on management commentary as a whole and on the various elements that might be expected within management commentary. Generally both investors and non-investors believe that some external assurance should be provided. Fund managers and analysts appear significantly less positive about providing assurance on management commentary than the other two investor groups but there is a wide diversity in the views of professional investors. Generally, analysts were less positive about the desirability of assurance than were fund managers. However, there was agreement, even among those not convinced of the need for assurance, to the effect that auditors could at least report on the consistency of management commentary with the financial statements.

In the interviews, individuals who were positive about assurance cited alleged inconsistencies between narrative statements and the hard data currently audited. They argued that auditors should curb excessive optimism in management commentary and encourage directors to be more transparent. One fund manager commented:

> *I think there has to be some independent review of what actually is going into the financial statements in a written form. I think the auditors are the most appropriate people to undertake that review because you cannot have a situation where you have a set of numbers being produced, which have been subject to audit and then have a completely separate commentary, which is not subject to review or is not examined in context or for consistency in terms of what it refers to... If management commentaries are not subject to review, management could put in whatever they like.*

One private shareholder suggested that the answer is for auditors to be involved at an earlier stage:

> *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.*

Interviewees who did not favour assurance argued that auditors would not be able to report meaningfully because they lacked the resources to challenge directors in subjective areas such as strategy, risk management and future prospects. There was concern that assurance on management commentary would inhibit directors, reduce the quality of disclosure and increase the use of 'boilerplate'. At the same time, most respondents indicated that assurance was at least desirable in principle. One fund manager stated:

> *In a perfect world, if you knew the management commentary was being assessed then that would be helpful.*

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

Various views were expressed regarding assurance on the different categories of management commentary content. Both investors and non-investors generally placed greater importance on assurance of past results, performance measures and indicators. 'Key resources, relationships and risks' were also regarded as important by both constituencies. While it was straightforward to provide assurance on historic, factual content, assertions on risks and forecasts were less easily verified. Some participants, however, argued for a robust approach to assurance on future information. The importance of consultation with directors before the management commentary was produced was stressed as helping to moderate excessive optimism and the omission or defective evaluation of significant risks. Some interviewees, however, argued that any auditor involvement in this area would tend to be *ad hoc* and that opinions expressed could not be formulated in true and fair view terms. On 'softer' content, one view was that auditors could report appropriately in 'softer' terms; for example, to the effect that management commentary assertions were 'reasonable' or 'not unrealistic' in the light of known information. This might again provide comfort to users without access to the more exclusive reports and briefings available to fund managers and analysts to triangulate evidence. Concern was expressed by one or two interviewees that assurance on future information might give rise to auditor liability problems and that it might be necessary to develop safe harbours for both directors and auditors, offering some protection for predictions made in good faith which turned out to be incorrect.

In summary, both investors and non-investors generally believe that at least some minimum level of assurance should be provided on management commentary but with relatively greater emphasis on more obviously 'verifiable' aspects such as 'past results' and 'key resources, risks and indicators'.

The scope of assurance on management commentary

Opinions were elicited from the investors participating in the research as to the form of assurance that might be applied most appropriately to management commentary. The 'content' approach was generally seen as more appropriate for the more factual aspects of management commentary and the 'lighter-touch' approaches – 'process' or 'consistency' – for the more subjective or qualitative elements. Consistency reviews were generally envisaged as a minimum desired level of assurance by all users, including those less positively disposed towards management commentary assurance. There was even some suggestion that auditors should be doing this already. One business user stated:

> *I think you certainly would want to know if it was consistent and one would make the automatic assumption that it was unless somebody said otherwise.*

Amongst fund managers and analysts, especially, there was little enthusiasm for reporting on process because a variety of possible approaches implied that auditor comment was unlikely to be meaningful. Additionally, it was stated that it is not process that determines the accuracy of statements, but the quality of the people writing the statement; that went beyond process. A minority of interviewees did believe that auditors should be responsible for robust assurance on the entire management commentary content, recognising that content assurance would also embrace process and consistency. On the other hand, most interviewees acknowledged that the temporal dimension was crucial. One fund manager commentated that:

> *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, perceptions, views etc., so as far as the past is concerned I would be more positive as far as assurance on content is concerned.*

There were suggestions, however, that although it was unreasonable to expect auditors to opine on future information in the same terms as historic information, they could at least say something. One fund manager observed:

> *It's only a forecast, but there has to be evidence to substantiate these remarks.*

Here the distinction between the different levels of audit assurance begins to become blurred. Auditors may look for evidence to substantiate forecasts based on the *process* 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 itself. And arguably an examination of management assumptions constitutes an audit of *content* in the context of future information.

Overall, the need for a holistic approach to corporate reporting and the related assurance was emphasised. At present, there is some confusion over which sections of an annual report are audited. One fund manager stated his view firmly:

My own view of the future, as you can gather, is one where the financial statements will be audited ,narrative reports will have a degree of assurance and they 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.

Cost was not a significant driver of the preferred approach to providing assurance on management commentary. There were interesting comments by interviewees on the implications for audit firms of providing assurance on management commentary. While several individuals stressed that audit firms should be able to provide 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 auditors, as possible obstacles.

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

7. Enhancing the value of external assurance: process, reporting and dialogue

Considering perceptions as to whether or not auditors should report on management commentary naturally prompts extension to the scope and value of audit reports generally. These, in turn, are likely, to partially reflect stakeholder views of the audit process underpinning audit reporting. Additionally, considering the more qualitative and judgmental aspects of management commentary may present an opportunity to refocus the audit in ways that are more beneficial to stakeholders. The final research objective, therefore, was to investigate users' confidence in the audit process and their views on current audit reports.

The audit process

In general, both investors and non-investors were only mildly confident in the external audit process. There was, however, a wide diversity of view and significant elements of all participant groups appeared to be unconfident in the audit process. The key fund manager and analyst group exhibit the lowest level of confidence and cannot be regarded as even mildly positive as a constituency.

Users who were positive about the audit process tended to emphasise post-Enron developments such as partner rotation and more robust internal review processes. Others stated their faith in the audit product almost as a presupposition for the reliance they placed on financial statements. One fund manager stated:

> *I ask myself a question: if I have a company that has produced an audited set of accounts do I feel better about it 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.*

Negative views ranged from the mildly concerned to the vitriolic. Concerns included the business model commonly adopted by the auditing profession in terms of the level of staff deployed on audits and a concern that the audit continues to be process, rather than judgment, driven. Such considerations may affect the perceptions of professional investors as to the value of assurance on management commentary itself. An issue for some investors, both professional and private, was the level of professionalism within firms, particularly as regards the exercise of professional judgment. A fund manager summed up by saying:

> *The nub of our concern is the question of professionalism. 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 in doubt; 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 being done badly, but I think there is a risk that the profession has lost its professional nerve.*

When asked whether there was too much emphasis on auditing standards the same fund manager replied that:

> *I think there is a risk that there has been too much detail ploughed into these things. 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 to do, not follow this or that checklist – exercise judgment.*

There was some, possibly surprising, negative opinion about the way external audit is arranged within capitalist economies and the resulting impact on auditor 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 where they assessed companies independently.

While there were concerns about the independence of auditors among institutional investors and their representatives, the views expressed were fairly moderate. In contrast, more extreme views were held by some of the private investors to whom we spoke, although it is fair to say that these may not be representative of private investors as a whole, for example:

I rant and rail about the audit profession and I would love to see it freed from the thrall 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' ... of course UK plc would fight that to the death but that might make a difference.

Usefulness of external audit reports

A lack of confidence in the usefulness of current audit reports was exhibited by all stakeholder groups. A tiny minority of research participants regarded audit reports as 'very useful' and a significant proportion saw them as not very useful or worse. The views of fund managers and analysts on this issue were the most negative of the various groups who participated in the research and several interviewees expressed their frustration at what they perceived as virtually meaningless audit reporting. There is, therefore, an evident urgency for initiatives to enhance audit report usefulness. Initiatives such as the 2007 APB discussion document *The auditor's report: a time for change* should result in radical revision of existing audit reports, rather than in merely minor or relatively cosmetic amendments, if changes to audit reporting are to meet investor needs. One fund manager summed up the predominant view by saying:

> *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 yet if you look at it now 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 that it's actually terribly helpful to anyone.*

Some users do not read audit reports at all because of their 'boilerplate' nature. One private shareholder commented:

> *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 to require people to certify great long lists of stuff, which are purely formal and are liable only to persuade everybody to ignore them.*

A number of suggestions were made to enhance audit reports such as incorporating information regarding future risks and uncertainties and including commentary by auditors on their own work. Some individuals suggested that audit reports might usefully reflect shades of grey rather than just formulaic 'true and fair view' statements. One fund manager suggested that:

> *Auditors perhaps need to make it clear that the audit report isn't just black or white, pass or fail – there are nuances. If they could somehow move to reflecting these, then that would be enormously helpful.*

The incorporation of information within audit reports about subjective or sensitive issues would clearly be regarded as a useful innovation by most stakeholders. 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.*

The consensus of opinion was such that it is unsurprising that most interviewees viewed the more radical possibilities for audit reporting exposed by the discussion paper (APB, 2007) published by the UK Auditing Practices Board (APB) positively. Interviewees were asked specifically about the reporting model highlighted in the APB document along the lines of French audit reports. Typical comments included this from a fund manager:

> *This* [an example of a French audit report] *is interesting in they have made specific comments about accounting treatment here; 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.*

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

Enhancing investor-auditor dialogue: other possibilities

The interviews explored investors' views as to how interaction with auditors might be enhanced. There was reiteration of the familiar point that present contact between investors and auditors is virtually non-existent with the AGMs being largely fairly meaningless rituals:

> *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?... So there might be an opportunity for something worthwhile instead of what we have at the moment...*

Possibilities for change included the facility for auditors to be questioned at AGMs but there were reservations expressed on this due to confidentiality considerations. Other channels of communication suggested included discussions with auditors in conference calls or even private meetings, although again there were concerns about confidentiality or the disclosure of inside information. One sell-side analyst made a connection between facilitating this type of investor-auditor dialogue and the auditor opining on qualitative matters:

> *The auditors should ensure shareholders' interests are taken care of so, why shouldn't there be a 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.*

Because of the confidentiality issue, some investors believed that audit committees were the most appropriate conduit for auditor-investor dialogue:

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 that 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 information that gives them confidence.

In summary, there is a strong current of opinion in favour of re-establishing the historic relationship between shareholders and auditors although views differ as to how this might best be realised.

8. Overall summary and policy recommendations

In brief, management commentary is regarded as valuable and its value to users seems likely to increase. There is a significant demand for at least some degree of external assurance on management commentary. These results are juxtaposed with user perceptions of an audit process which is only of moderate value in some cases and of external audit reports that are of very limited value. There is a desire on the part of users for auditors to improve communication with investors and other stakeholders by more meaningful audit reports and, in some cases, 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 the audit profession.

There is a desire on the part of users for more useful audit reports and for conduits for meaningful dialogue between auditors and shareholders and other stakeholders. While the UK APB has taken some tentative steps towards more informative audit reports (APB, 2007) there is 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 relates specifically to the audited entity. Similarly, there is a need for policies that aim to reinstate the 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 various possibilities including the use of either or both of audit committees or AGMs as fora for meaningful auditor-shareholder dialogue. Research is therefore necessary in order to determine the detail of the required policies. Other findings require further consideration, particularly through exploration with the audit profession, before policy details 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 – this is currently being investigated in the second stage of this project. There is an opportunity, however, for research to go beyond these immediate issues and to explore how the external audit might be enhanced so as to 'add value' to those who rely on it.

9. Wider issues and implications

Evidence of opinion in favour of revisions to the external assurance function including, for example, more useful audit reports and more substantive investor-shareholder dialogue appear to sound a note of discord with some influential elements of professional opinion. Some professional voices highlighted in the accountancy trade press have suggested that it is 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 this research project offer an alternative perspective.

Interestingly, a connection was made by some investors between enhancing auditor-investor communication and providing assurance on the more qualitative aspects of management commentary. Issues arising from user perceptions of the audit process and audit reports, therefore, resonate with the question of management commentary assurance that constitutes the core of the present project. The issues are not mutually exclusive. This echoes a call made sometime ago in the academic literature (Hatherly, 2003) for auditors to 'add value' to investors, rather than to corporate management. One way by which auditors could add value in this way might be, in effect, by writing their own 'management commentaries'.

In this way, the immediate questions concerning management commentary lead on to considering a more fundamental question regarding the future shape of the external assurance function in twenty-first century capitalist societies (see Fraser and Pong, 2009). What do investors, other stakeholders and society want from external assurance? Will the audit profession respond to user concerns in ways which add value to investors and other users?

Reflection on these wider concerns is particularly timely. While discussion of the external audit role in the recent crisis has been muted, questions have been asked by prominent public figures about the contribution of auditors to recent events. Such connections were made in less public fashion in the course of the present research; for example, by users arguing for audits with more of a business risk focus. This is ironic given the apparent retreat from ‘business risk auditing’ post-Enron. The fallout from the economic and financial crisis may encourage government, regulators and significant stakeholders to be more receptive to more radical solutions than at any time in the recent past. It may be timely for the audit profession to consider how best to enhance its economic and societal contribution. Otherwise it is not inconceivable that rather than the issue of the day being one of how to make audit more useful the issue will be one of whether or not external audit in its present incarnation is useful.

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About SATER

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

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

Nigel Macdonald
Chairman of SATER

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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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