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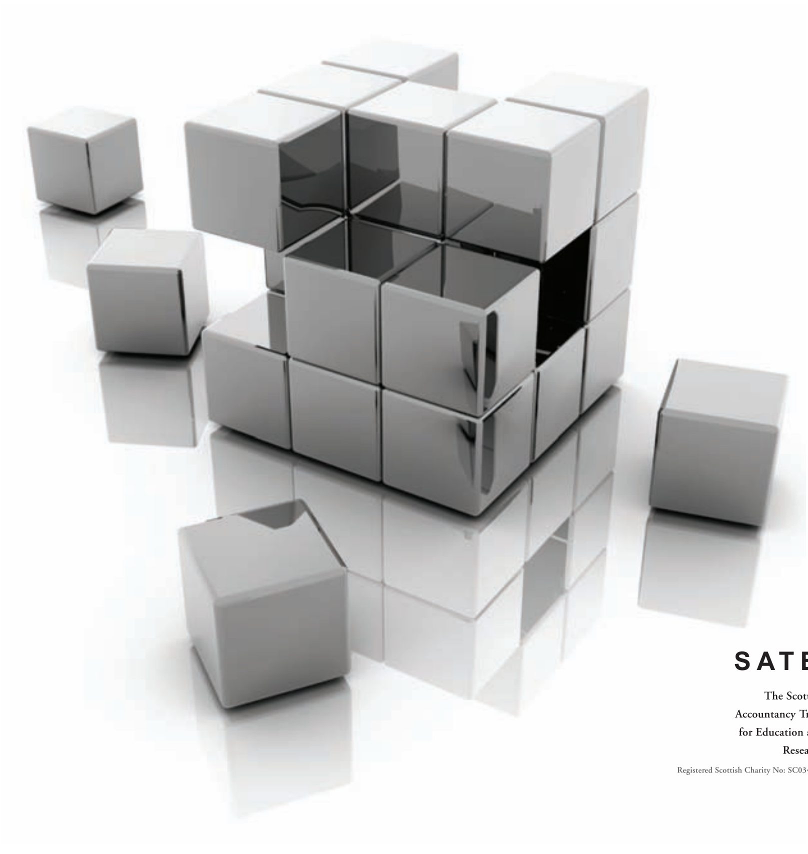
Can we meet the needs?

Auditor views on external assurance and management commentary

Summary Report

Ian Fraser



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Research summary report

Can we meet the needs?

Auditor views on external assurance and management commentary

by

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Foreword

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

This research summary report drafted by one of the authors of the full report provides a good summary of this project and its findings. The full report can be downloaded free of charge at www.icas.org.uk/fraser-auditors. The report arising from the first stage of the project which investigated the views of users can be downloaded at www.icas.org.uk/fraser-users.

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

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

This project was funded by the Scottish Accountancy Trust for Education and Research (SATER - see page 32). The Research Committee of The Institute of Chartered Accountants of Scotland (ICAS) has also

been happy to support this project. The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that the project will take forward the debate about the future of assurance. The Committee is pleased that the findings of this report were also useful to the ICAS working group, which included Ian Fraser, which was responsible for the recent ICAS publication The Future of Assurance (www.icas.org.uk/futureofassurance).

Allister Wilson
Convener, ICAS Research Committee
September 2011

Acknowledgements

Sincere thanks are due to all those who made this research possible. We would like to thank all the auditors who replied to the postal questionnaire survey and who, in many cases, took the trouble to supply extensive additional comment. We are especially thankful that so many auditors were willing to make time in their diaries to be interviewed; indeed, we were unable to interview all volunteers and we apologise to those whom we were unable to accommodate. Clearly many auditors are concerned about both the threats and opportunities currently facing the profession; this bodes well for its future development. We are also grateful to the representatives of several regulatory bodies who agreed to be interviewed. For confidentiality reasons, none of the interviewees were named here but both the researchers and the ICAS Research Committee appreciate their contribution greatly.

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

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1. Introduction

This short publication provides an accessible and non-technical summary of the second stage of a major research project supported by The Institute of Chartered Accountants of Scotland (ICAS) on the future of external assurance. Those interested can obtain a fuller account of the research from the ICAS monograph (Fraser and Pierpoint, 2011) which is published concurrently with this summary (download at www.icas.org.uk/fraser-auditors). The major concerns of the research are to investigate, first, the desirability and feasibility of providing external assurance on management commentary and, second, the usefulness of current audit reporting and ways of enhancing that reporting. The first research stage covered the views of professional and private investors, and other users, on the issues and the complete results may be accessed in the published research monograph (Fraser *et al.*, 2010). A short summary report is also available (Fraser and Henry, 2010). This second stage investigates the views of auditors, and to a lesser extent, those of regulators.

2. Background

External audit, or assurance, as it exists in the UK and in other major economies, may be set for unprecedented change. There is a growing realisation, prompted by pressure from investors and other users, that assurance is not provided presently on the most appropriate things and that the associated reporting might be revised radically to the benefit of users. Similarly there is a sense auditor-shareholder relationships might be enhanced generally while there are also concerns about audit quality, including the respective emphases placed on process and judgement. The recent financial and economic crisis has led to these issues featuring in professional, regulatory and political discourse.

The background to the research is explained in greater detail in the reports on its first stage (Fraser *et al.*, 2010; Fraser and Henry, 2010) which investigated the above issues from the perspective of both investors and non-investor users. The first stage of the research highlighted users' desire for some assurance on management commentary and the 'front-end' of the annual corporate report generally. There is a major user concern about the usefulness of current audit reports and some concern about the robustness of the external audit. There is some will to enhance auditor-shareholders links. It is therefore important to explore the views of auditors themselves on these issues and their response to users' concerns.

Other developments reflect concerns arising from the recent financial and economic crisis, underlining the importance of exploring auditors' ability and willingness to respond to users. Pronouncements by regulators and professional bodies have reinforced the growing opinion in favour of both more entity-specific audit reporting and assurance on the 'front-end' of the corporate report while also highlighting audit quality issues. Thus the financial services faculty of the Institute of Chartered Accountants in England and Wales (ICAEW), in its recent report on the audit of banks (ICAEW, 2010), has suggested that auditors should have more involvement in reporting on the front sections of annual reports and, in particular, that auditors might report on whether ‘there are any material omissions in the information provided in the front section of reports, based upon the auditors’ knowledge of the bank they are reporting on’ (ICAEW, 2010, p. 10). It is also suggested that auditors should provide assurance on new ‘summary risk statements’. These suggestions resonate with some opinion in the large auditing firms in favour of auditing the ‘front of book’ where companies outline their business model and risks (Christodoulou, 2010). John Griffith Jones, Joint Chairman of KPMG Europe LLP, has made similar points in a speech to the ICAEW (Griffith-Jones, 2010), stressing such phenomena as the declining incidence of basic accounting errors and, correspondingly, the relatively much greater importance of higher level financial, as well as non-financial, risks. The obvious point was made; auditors need to perform in these more complex areas, for example, by forming a view on the risk assessments and forward-looking data in the ‘front-end’ of annual reports.

As far as audit reporting generally is concerned, the House of Commons Treasury Committee (HCTC), in its ninth report, specifically on the banking crisis, for 2008-9, has argued for more ‘graduated’ going concern opinions (HCTC, 2009, para.243). At the same time, investor views on the desirability of reforming audit reports continue to be highlighted in the accountancy and other business press (see Christodoulou, 2009; Hinks, 2010; Sanderson 2010). In terms of responses from professional and regulatory bodies, the UK Auditing Practice Board’s December 2007 discussion paper on the future of audit reports (APB, 2007) has been followed by a number of related initiatives. A consultation report prepared for the Technical Committee of the International Organisation of Securities Commissions (IOSCO, 2009) acknowledges the questionable value of standard audit reports and highlights different possible remedies without recommending specific solutions.

An internal report prepared shortly after the IOSCO consultation for the International Accounting and Assurance Board (IAASB, 2009), while stating that users value auditors’ reports, particularly when qualified, has reiterated that users do not view standard audit report content as useful and that they would like reports to be more informative both as regards the audited entity itself and the audit work and findings relating to particular audits.

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

Concerns over judgement in auditing go beyond reporting. Another recent UK report (FSA & FRC 2010) considering external audit and assurance within the financial sector, and produced jointly by the Financial Reporting Council (FRC) and the Financial Services Authority (FSA), is forthright in its view that auditors need to do more to challenge management and that auditors sometimes display a 'worrying lack of scepticism' (FSA & FRC, 2010, p.8) in relation to management judgements. It is suggested that auditors, rather than challenging these judgements and applying an attitude of scepticism to them directly, have sometimes tended to focus over much on identifying evidence which would readily support managerial judgements and their compliance with accounting standards. The European study sponsored by the GPPC (MARC, 2010) is rather more circumspect and less critical of auditors than is the FSA and FRC study, but indicates that stakeholders who participated in the study would 'like to see the audit model reconsidered to offer a less compliance driven, more comprehensive approach that additionally offers a broader, more holistic view of the business' (MARC, 2010, p.4). The September 2010 European Commission (EC) Green Paper (EC, 2010) represents a more official European response to the issues and the discussion document *The Future of Assurance* (ICAS, 2010b) that of The Institute of Chartered Accountants of Scotland.

These varied developments add force to the results from the first stage of the research and underline the importance of exploring the responsiveness of the audit profession.

3. Objectives and research approach

The specific objectives are to identify the views of auditors on:

- the importance of management commentary to users;
- the need for external assurance on management commentary;
- the nature of the assurance which might be provided and the most appropriate way of reporting it;
- the robustness of the contemporary external audit process;
- the usefulness of current audit reports and how that might be enhanced; and
- other means of enhancing auditor-user communication.

The research included, first, a postal questionnaire survey of audit partners and other senior auditors (124 responses, response rate 17.8%) and, second, twenty three semi-structured interviews with auditors who responded to the questionnaire survey. Finally, the issues were explored in interviews with four representatives of organisations with an interest in auditing regulation. The following two sections of this report summarise the research findings and illustrate these by the inclusion of material from the interview transcripts. Section four deals with the specific issues relating to management commentary while section five deals with more general issues relating to perceptions of the audit process, audit reporting and auditor-investor dialogue. The report then concludes with an overall summary and policy recommendations.

4. Research findings: Management commentary

The first research question explored auditors' perceptions about management commentary itself. Auditors believe that management commentary, and the 'front-end' of corporate reports generally, are important and that their significance for users will increase. Non-Big Four auditors hold more varied views, possibly reflecting a wider size range of audit clients. The perceived inaccessibility of IFRS-based financial statements is seen as a crucial factor in the increasing importance of management commentary to users with one auditor observing that:

> *Comments such as 'no one understands the back-end of financial statements any more' puts more emphasis on the 'front-end' narrative explaining the performance of the business in language that shareholders or investors understand.* (Non-Big Four Partner)

At the same time, there are reservations about the usefulness of much present commentary due to the prevalence of both management spin and boiler plate disclosure. It is consistent with these reservations that there is an element of opinion which envisages a need not only for more useful management commentary but for a radical revision of the corporate reporting package as a whole with an emphasis not just on the financials but on the development of a more business-orientated reporting model. Initiatives such as that of ICAS (2010a) reflect such opinion but individual visions of future reporting go beyond this in some cases; for example, by providing a much more elaborate discussion of future prospects. One of the most radical views expressed was as follows:

> *The corporate report as it is today is irrelevant. I don't think that management commentary is really adequate. I would have really different financial statements. My model for financial reporting would be something very different to what we have at the moment. It would be more simplified, much more disaggregated. I don't have a vision of business reporting which looks like the status quo plus*

> *a new management commentary; I see the whole package as being completely different. No matter what you prescribe you will always sink to the lowest common denominator, you will always have some boilerplate. So I think you have to look at it holistically in terms of content, the assurances given and the role of the auditor. You are then giving the auditor a much more pro-active role in ensuring full and fair commentary that takes you out of boiler plate.* (Big Four Partner)

Assurance on management commentary

The second and third research questions explored perceptions regarding management commentary assurance. Generally, auditors' views on the need for management commentary assurance reflect the significant emphasis which they place on the commentary itself. Assurance is regarded as important and auditors are significantly more positive than investors, who themselves have positive views on the issue, on the primary issue as to whether or not external assurance should take place. The following statement highlights the fundamental point that a significant element of auditor opinion believes that the profession requires to react positively to user demands for assurance over management commentary.

> *I think that from the contact we have with stakeholders across the spectrum of large private and public companies there is an inexorable pressure that says they want some assurance and therefore as an audit profession we have to react to that. The overwhelming majority of stakeholders seem to be asking for some assurance around it. There are very, very few that are prepared to give management free reign without some external check on what they are saying.* (Non-Big Four Partner)

In terms of the assurance on the individual elements of management commentary, auditors score the need for assurance on some of these as greater than investors while the converse also applies. In terms of the key content element of 'future prospects' there is no significant difference between the respective opinions of auditors and investors. One senior audit partner emphasised the importance of auditors not neglecting the future dimension, as follows:

> *I gave our guys a challenge the other day… if you look at our area of assurance we spend 90% of our time on the past and 10% on the future in terms of going concern and such like and actually if you look at the city they spend 90% of their time on the future and 10% on the past. Arguably, it's because our job is to give them the firmness on the past and their job is to look at the future, but do we give them enough?* (Big Four Partner)

On exploring the issues in depth, unsurprisingly, auditors appear to believe that assurance over content is more feasible for the less problematic elements of management commentary. For the less straightforward, especially qualitative or future-orientated, elements, there is a preference for assurance over the process followed when preparing the management commentary or for ensuring consistency with the financial statements. Even in the case of the most complex elements of management commentary, a substantial proportion of auditors believe that one or more of the proposed approaches to assurance (consistency, process, content) are possible.

The preferred approach to assurance on management commentary is one of the relatively few issues addressed by the research where there is a clear divergence of view between Big Four and non-Big Four auditors with the former showing a relative preference for a process form of assurance; this may possibly reflect relatively greater familiarity with systems-centred assurance.

A major research finding is that there is relatively little opposition to management commentary assurance in principle and that objections to assurance are largely non-technical. For example, parallels were drawn by auditors between assurance work on future-orientated financial information and the technical nature of work already carried out, for example, in a due diligence context. One auditor suggested that as far as assurance on forecasts was concerned:

It shouldn't be beyond man to find a way of doing it because, frankly, you do it on diligence assignments and the like. (Big Four Partner)

Similarly, it was pointed out by several auditors that they already carry out what amounts to an informal assurance process on management commentary. Positive comments were made about the ability of auditors to opine on areas with a qualitative dimension and which are not necessarily closely related to the financial statements. Risk is one such area and the positive attitude which many auditors hold as to the possibility of meaningful engagement with the risk area indicates a rather more optimistic assessment about auditors' capabilities, perhaps predictably, than does a recent report of the UK House of Commons Treasury Committee (HCTC). For example, one auditor stated that:

Interestingly, risk is an area where we should be more comfortable because of course we rely heavily on risk driven processes to drive our risk based audit. So it should be an area that we are pretty comfortable with. (Big Four Partner)

Thus while the HCTC has suggested (HCTC, 2009) that auditors have only limited capability to provide assurance on the risk management of banks, auditors believe they have more competence to offer in this area than their present limited involvement might suggest. It appears from the conversations held with auditors that it may become necessary for auditing firms to recruit non-financial specialists and there is some suggestion that relatively smaller firms may be potentially disadvantaged in this regard. While obstacles in the way of providing management commentary assurance are not viewed as being fundamentally technical, non-technical obstacles are viewed by auditors as much more significant. Three distinct, but related, matters stand out.

First, it appears that a significant proportion of auditors believe that providing assurance on management commentary, and particularly, its more judgemental elements, would result in the blurring of management and auditor responsibilities. For example:

We don't know the market in which businesses operate, that is not our role, is it? We know generally but we don't know the detail. And we have absolutely no idea about how business is going to fare in the future. And I think to start commentating on that and giving any sort of assurance on that may well be extending slightly into the management role. (Non-Big Four Partner)

While we try to understand the business it's really management who have got a grasp of the whole picture. (Big Four Director)

Concerns of this nature do not relate to management commentary alone but to any assurance process which engages with managerial judgements. Thus such concerns also impact potentially on arguments for the enhancement of audit reports by providing them with a more judgemental or entity-specific character.

Second, there is a related concern in respect of the way in which auditors could feasibly report on management commentary. A comparison of the respective questionnaire responses, made by users and auditors, regarding the appropriateness of various methods of reporting assurance on management commentary indicates that auditors are significantly less favourably disposed to reporting on management commentary via the standard audit report than are users. The subsequent interviews with auditors clarified the reasons for this reluctance as comments were made regarding the difficulties inherent in providing management commentary assurance in true and fair terms. This reflects the significant 'soft' content in management commentary.

The opinion would have to be kept separate from the opinion on the financial statements, which is the back half. In a way that's what happens at the moment because there is an element concerned with the directors' report and that's the subject of a separate line in the opinion. (Big Four Partner)

Other points were also made as to how a limited, or heavily caveated, form of reporting might apply to assurance on management commentary.

> *You would have a true and fair report on the financials as they stand and something less than that - whether it's a report on process or in terms of we have carried out procedures, a, b, and d or whatever - in respect of the future forecasts, for example.* (Non-Big Four Partner)

Interestingly, while auditors are relatively enthusiastic about standard audit reports in general but relatively unenthusiastic about extending their scope to include management commentary, the reverse applies in the case of users. This may indicate that in the long term the future of the true and fair opinion may become problematic, as the 'front-end' becomes relatively more significant compared to the financial statements themselves. None of the reporting options on management commentary proposed to auditors attracted clear majority support; there is a challenge, therefore, to develop a specific and acceptable reporting model.

Given calls for cohesive and 'joined-up' corporate reporting, it seems opportune in the long run to develop a form of reporting that covers assurance on both the 'front' and 'back' of the annual report. This logic is reflected in the thinking of an auditor who stated that his

> *...vision would be that our job is to make sure that management is giving a fair and reasonable assessment of the past performance and prospects for the future.* (Big Four Partner)

Third, auditor liability is certainly envisaged by many auditors to be a significant obstacle to extending the scope of assurance. It was argued that it is the particular liability implications of the 'front-end' which require two separate assurance or audit reports rather than one single report covering the annual report in its entirety.

> *One part of me says that is a level of detail which I think we sweat over which isn't necessarily helpful. The only reason you get the separation*

> *issue, frankly, is because of the liability thing. If we could fix that distortion, there is no reason why we couldn't have a comprehensive report on the financial statements as a whole.* (Big Four Partner)

In the same way as obstacles to providing assurance on management commentary are not viewed as being fundamentally technical, auditors do not envisage that the financial implications of providing assurance are likely to prove an insuperable barrier to assurance although opinions do vary widely as to the incremental cost. While some auditors suggest that it is impossible to put a meaningful figure on the likely percentage increase in overall assurance costs, the mean increase suggested is in the region of around twenty-five percent.

The views of regulators who contributed to the research are similar to those of auditors; they do not see technical or financial issues as being major obstacles to the provision of assurance on management commentary. It was pointed out that professional firms should be able to source additional skills as required, that some revision of the traditional staffing models customary in professional firms might become necessary and that higher assurance costs should result in lower costs of capital.

In summary, the views of both auditors and users (identified at the first research stage) indicate strongly that the time has come for the profession to produce firm proposals for some form of assurance on management commentary. There are issues in respect of liability, the specific form of reporting to be adopted and the demarcation of auditor and management responsibilities which invite serious reflection if meaningful progress is to be made on the issues. It may be inappropriate, however, to consider the management commentary issues in isolation as there is a view held strongly by some thoughtful members of the profession that current assurance and corporate reporting issues are not mutually exclusive. Such thinking emphasises the importance of developing a more radical, useful and cohesive corporate reporting and assurance package.

5. Research findings: Process, reporting and dialogue

Process and judgement

The fourth research question explored auditors' perceptions as to the robustness of the external audit process. While the questionnaire survey responses suggest that auditors are generally neutral on whether regulation has affected the relative emphases placed on judgement and process in the audit process, the auditors who were interviewed for the research generally viewed the impact of regulation on auditors' exercise of judgement negatively. There is some perception that regulators equate audit quality with compliance with rules.

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

> *Recent developments in auditing standards emphasise compliance. We now have a situation where 80% of time spent on an audit is there to justify regulators and does little to enable the auditor to form a proper view on the financial statements.* (Questionnaire comment)

Some auditors are clearly aware, however, of the difficulties faced by regulators and are careful not to overstate the argument that the contemporary audit environment affords diminishing scope for auditors to exercise judgement.

> *I think you fundamentally still can make judgements and I think it is just a question of being clear about what they are and how one has arrived at them and documenting that appropriately in the eyes of*

the regulator. So I don't think it is something you blame per se on the regulators. (Big Four Partner)

Auditor perceptions of decreasing scope for exercising judgement echo the views of users identified at the first stage of the research. There is, however, some acknowledgement of reasons other than regulation for an increasing reliance on process or rules and/or declining scope for the exercise of judgement.

> *The younger guys are very bright, they are off the wall… nothing is out of bounds. We come in and it is smack, smack, smack!… this is the methodology, the procedure, you have got to follow, you have got to do that, you have got to do it properly… and then we expect them to be off the wall guys and advising our clients on acquisitions and new systems and so on… We force that creativity out of them and then we expect them to be creative.* (Big Four Partner)

This acknowledgement by auditors themselves reinforces a view expressed by one regulator that the main driver of process was the drive by the large professional firms to ensure uniformity of approach throughout their global operations. Whatever the reasons for the arguably increased emphasis on process there are some perceptions that moves towards providing assurance on management commentary and on the 'front-end', may facilitate, or even necessitate, an intensified emphasis on judgement.

> *In some senses you can say going into the management commentary actually allows a greater focus on judgement… I got a set of client accounts sent through to me the other day from of one of my senior managers and she said 'I'd really like you to focus on the management commentary…' and actually where I make the biggest difference, to be honest, is actually on the review of that commentary… Does it make sense? Does it fit the business?… as opposed to they've done the checklists on disclosure and such like.* (Big Four Partner)

These impressions are echoed by the 2010 joint call by the FSA and the FRC (FSA & FRC, 2010) in the UK for auditors to exercise more scepticism and to challenge management more rigorously. Widening the scope of assurance to include the 'front-end' of the corporate report and a more robust engagement with management may make some revision of customary professional firm staffing and business models appropriate. Professional firms require to be open to such developments.

Audit reporting

The fifth research question was concerned with auditors' perceptions as to the usefulness of contemporary audit reports and what might be done to improve that usefulness. Of all the areas addressed by the present research, audit reporting exhibits the clearest divergence of view between auditors and users due to the significantly different views which each constituency holds as to the usefulness of existing audit reports with auditors being much more supportive of the true and fair view and the standard binary opinion.

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

Auditors also appear more wedded than users to generic style reports where detail of key judgements or of the audit remain hidden from users.

> *Do you* [the user] *really want the explanation?* [of audit judgements]... *Well, actually what you want to do is to audit it yourself... That is the logical extension. It is not enough for me as an auditor to tell you that my professional judgement is that it is*

appropriate and that it is a true and fair view. You don't actually believe me. (Big Four Partner)

While the audit report is standard wording it is basically a disclosure, with the opinion having very prescribed use. Therefore, to the informed reader, it has a very clear meaning. It may be that the meaning should be clearer to everyone. (Questionnaire comment)

The thinking underpinning such views is consistent with many proposed improvements to audit reports being essentially similar to past attempts at enhancement by including more generic material of an ostensibly 'educational' nature. Many thoughtful auditors, however, recognise a need for the profession to respond to the strongly-articulated views of users to the effect that audit reports require to incorporate much more entity-specific material. Indeed many auditors believe, in principle, that they should 'say more' and that investors and other stakeholders should receive audit reports which are more obviously useful to them.

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

There are various forms which more expansive audit reporting might take; while they are not mutually exclusive, the two principal possibilities, based on the previous stage of the research which might be acceptable to users, are more entity-specific detail on either the audit process itself or the key judgements which are critical to the financial statements and/or the audit. One of the auditors interviewed who was most receptive to the possibility of much more entity-specific audit reports envisaged:

...a report of the audit process, what we started with, the information that management presented for audit, what we considered a risk, and how those risks were subsequently resolved through discussion

and with management, what issues we disagreed with and the quantification of those issues which remain unresolved but didn't affect our binary opinion... a very different audit environment. (Non-Big Four Partner)

As perceived by auditors, the obstacles to more entity-specific audit reports are similar to those identified in respect of management commentary assurance. Liability issues are seen in much the same way; this is unsurprising as assurance on management commentary, with its significant 'soft' and 'subjective' content of a judgemental nature, has much in common with an audit reporting model which focuses on and highlights specific matters of judgement. Reporting on the more subjective content inherent in management commentary is perceived to have liability implications similar to those which would result from more entity-specific audit reports, hence auditors' evident lack of enthusiasm for reporting on management commentary by means of the standard audit report in terms of truth and fairness.

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

As in the case of auditor liability, the potential for confusion, or at least conflation, of management and auditor responsibilities is also seen as a possible barrier to more informative audit reporting. This may have the potential for affecting auditor-management relationships adversely and affecting the dynamics of governance. There is some perception that management would regard more detailed judgement-centric audit reports unfavourably, although this remains to be tested empirically. One way of implementing more informative audit reports could conceivably be to put something like auditors' existing reports to corporate audit committees into the public domain but some auditors perceive that this may inhibit auditor-board relationships.

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

In summary, more useful detail in audit reports is technically possible. As in the case of management commentary, however, it may be necessary to achieve some resolution of the liability issue as a condition of progress. The implications for governance, perhaps most especially company director-auditor relationships, require exploring with preparers and with non-executives. More radical auditor views have some similarity with those on a more cohesive and business-orientated corporate reporting package; there is the suggestion, for example, that auditors might write their 'own' management commentaries on those of management themselves.

> *That would be an interesting development. If you think about the long term attractiveness of audit as a profession this is something which I think could actually help to make it more attractive.* (Non-Big Four Partner)

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

In the long run, the existing audit reporting paradigm, grounded in a binary model articulated in terms of 'truth and fairness', may not be sustainable if the focus of the assurance provision on corporate reports gradually assumes a more future-orientated character.

Auditor-investor dialogue

The sixth and final research question was concerned with how more substantive relationships between auditors and investors might be facilitated. How to facilitate more substantive auditor-investor relationships is a current issue related both to audit reporting and to assurance on management commentary. Extended audit reports may be one of the more straightforward means of enhancing auditor-investor dialogue while at the radical end of the spectrum of opinion the suggestion was made that for auditors to write their own commentaries on that of management would constitute a very effective way of enhancing auditor-investor dialogue.

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

In terms of more specific ways to improve auditor-investor dialogue, the prospect of 'cold' questions to auditors at AGMs is not regarded with enthusiasm by auditors and private meetings between auditors and major investors are largely regarded as unacceptable. This is, of course, unsurprising in the context of the prohibitions on insider dealing but nevertheless highlights an apparent anomaly; the simultaneous existence of one-to-ones and other meetings between corporate management and other investors. There is an interesting moral dilemma as to whether different standards should be applied to auditor-investor relations; from a corporate governance perspective this appears inconsistent. Written questions to auditors in advance of AGMs, or the use of websites, however, appear to be regarded by auditors as feasible ways of enhancing dialogue with investors.

Less radically, and although not incorporated in the questionnaire, the role of audit committees, or non-executives generally, in communicating with shareholders was highlighted specifically by questionnaire respondents and interviewees. There are different views held by those who favour audit committees as a means of enhancing auditor-investor dialogue. The conservative end of opinion emphasises the role of audit committees within the existing corporate governance framework as a surrogate for direct auditor-shareholder dialogue; a more radical perspective is that information available to audit committees might, under certain circumstances, be made available to specific investors who ask for it. Some auditors, however, emphasised that their duty of care is to the shareholder body and not individuals and there was a suggestion that existing governance structures make other forms of auditor-investor communication inappropriate.

Summarising, while the practical difficulties of implementing more effective auditor-shareholder dialogue are recognised, there is simultaneously a sense of its appropriateness in principle.

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

6. Overall summary, policy recommendations and further research

The report on the first stage of the research (Fraser *et al.*, 2010) identified a strong appetite on the part of users for change to the existing assurance function in terms of, first, extending its scope to the 'front-end' of the corporate annual report and, second, more informative and entity-specific audit reports. Less crucially, a desire to enhance auditor-investor communication through other means was also identified. These concerns have added momentum as a result of recent financial and economic events. This second stage of the research has identified that auditors are prepared to respond positively to these investor concerns.

In principle, at least, auditors seem prepared to provide assurance on management commentary and similar disclosures. There seem to be few purely technical obstacles to pushing out the boundaries of assurance in this way. Similarly, more useful audit reports and better communication between auditors and investors are regarded as technically possible although auditors, certainly as compared with users, are supportive of the existing true and fair view opinion. This propensity in favour of generic reporting reflects widespread auditor concerns about the liability implications which, it is perceived, may follow from changing either the scope of assurance or the generic nature of audit reporting. The strategic issues presently facing the audit profession, therefore, require that a longer-lasting and more acceptable solution to the liability issue is found than those attempts at resolution which have been made in the past. Imaginative thinkers representing both user and auditor constituencies envisage a response to these strategic issues in terms of some movement towards a cohesive and 'seamless' corporate reporting paradigm embracing not just the financials but key narrative disclosures and with an integrated assurance function on both. Despite the support of auditors for the true and fair view, a variety of factors may mean that the long-established UK model of audit reporting grounded in such generic terms as 'true' and 'fair' may have a limited long-term future.

These factors include the perceived difficulty of opining on management commentary in true and fair terms, a possible drive towards audit reports more centred on specific judgements and the thinking of some regulators. Other issues to be resolved, depending upon the solutions proposed, include consideration of the implications for corporate governance and the reaction of preparers and non-executives. Concerns of users about a possible over-emphasis on process in auditing at the expense of judgement are echoed to an extent by auditors, although there are varying views as to whether an increased emphasis on process is imposed on or by auditors. A change in the scope of assurance in terms of a more specific focus on management commentary may itself help to facilitate a more judgement-centred and less process-driven assurance function.

It is clear that over the user and auditor constituencies as a whole there is an appetite for significant changes to the assurance function - or, at the least, some acceptance of their inevitability. These undercurrents are echoed in many of the more high-profile initiatives and pronouncements from a variety of regulatory, professional and semi-official bodies. While the precise parameters of change may be problematic, and while many issues remain to be researched, it is clear that the time is now opportune for concrete policy proposals which can be explored with key stakeholders. These proposals should not be restricted to assurance but should incorporate, or at least acknowledge, proposals for more cohesive and easily accessible corporate reporting encapsulating data of both a financial and non-financial, and a quantitative and qualitative nature. The recent ICAS initiative (ICAS, 2010a) provides a possible starting point. Such proposals for corporate reporting need to be juxtaposed with a new audit reporting model that engages with all the above elements of corporate reporting and which goes some way towards encapsulating a more entity-specific and judgement-focused character.

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

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

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About SATER

The research projects which culminated in this publication were funded by grants from The Scottish Accountancy Trust for Education & Research (SATER) – a registered Scottish Charity (SC034836). The SATER Trustees are pleased to have been able to support these projects and hope that the results are of interest and relevance to a broad range of users.

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

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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.

David Spence
Chairman of SATER

September 2011

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

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

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