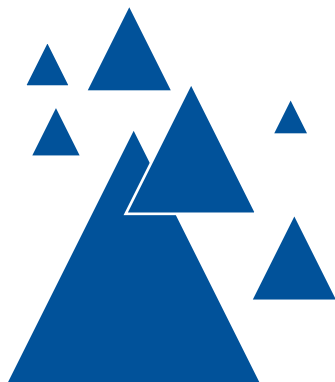




Meeting the needs? User views on external assurance and management commentary_____

Executive Summary



Researchers: Ian Fraser
Jacqueline Pierpoint
Bill Collins
William Henry

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E XECUTIVE SUMMARY

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

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

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

User perceptions as to the desirability of assurance on management commentary may hinge partially upon broader issues – perceptions of the robustness of the extant external audit process and of the value of existing external audit reports generally. User views on the underlying strength of the audit process, for example, are likely to influence perceptions of the ability of auditors to provide assurance on management commentary,

which has a relatively high proportion of subjective and difficult to assess content. Likewise, if existing audit reports hold only limited benefit for users then this demands resolution before the scope of audit reporting can be usefully extended. The research also takes the opportunity, therefore, to explore these broader issues.

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

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

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

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

Findings

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

- Users perceive the management commentary to be a useful corporate report; while at the same time, several factors, such as the use of 'boilerplate' language and the fear of being held accountable for unrealised predictions, are perceived to reduce its usefulness.
- Management commentary is perceived as being important in understanding corporate dimensions such as key resources, risks and relationships, past results, future prospects and performance measures and indicators but it is recognised that many of these attributes are vulnerable to management 'spin' and distortion. Specific constituencies of users, and even investors, differ in the importance they attribute to management commentary; some categories of expert user, for example sell-side analysts, have relatively little use for it. Differences between different investor categories might be usefully taken into account in future iterations of conceptual frameworks such as that of the IASB.
- While differing views on the relative importance of the negative effects of factors such as 'boilerplate' wording on the one hand and 'management spin' on the other, provide context for differing perspectives on the regulatory approach that should be adopted in respect of management commentary structure and content, most opinion favours a 'light touch' approach. The most favoured is one whereby the IASB, or

other regulator, would mandate a minimal template for the structure and content for management commentary but would permit some element of discretion and ‘corporate house style’.

- Generally, both investors and non-investors believe that it is desirable that at least some external assurance be provided on management commentary to identify inconsistencies between narrative statements and the hard data currently audited, to curb excessively optimistic directors’ statements and to provide more transparent disclosure. The perspective of professional investors, in general, is less enthusiastic than the average, possibly reflecting both a desire not to inhibit corporate style and content and scepticism about the capabilities of the existing external audit. In addition, some categories of expert users, perhaps analysts most obviously, have access to other information sources and have, therefore, less need for assurance on management commentary.
- Assurance on management commentary may be especially important for small investors or non-investor stakeholders; neither constituency is likely to have access to the alternative information sources available to professional investors.
- Different elements of management commentary content pose distinct challenges. Users are more positive about assurance on the more obviously ‘verifiable’ components such as ‘past results’ and ‘key resources, risks and indicators’ but views regarding assurance on ‘softer’ components such as ‘future prospects’ are less positive; there are perceptions that auditors might report in ‘softer’ terms; for example, whether or not these aspects were ‘reasonable’ or ‘not unrealistic’ in the light of knowledge at the time.
- Generally, there is a preference for applying more robust approaches to assurance, e.g. ‘audit of content’, to more historic and quantitative content elements of management commentary while applying softer approaches, e.g. ‘audit of consistency’, to ‘softer’ or qualitative elements.

- There is a general preference for communicating management commentary assurance in the standard audit report, as opposed to in a separate stand-alone version.
- Both investors and non-investors are, at best, only mildly confident about the robustness of the current external audit process; some are decidedly unconfident. Specific concerns include the perception that audits are often ‘process’, rather than ‘judgment’, driven.
- There is a high level of consensus across all users that current audit reports have very limited usefulness. There is an evident need and demand for audit reports to be radically enhanced to incorporate more entity-specific information and to better reflect the judgements made by auditors. Current initiatives, such as those of the UK Auditing Practices Board (APB), do not appear to be sufficiently radical in this regard. There is a need for auditors to ‘reconnect with investors’.
- Confidence in any assurance arrangements for management commentary seems likely to be enhanced should these more general concerns on the audit process and audit reporting be addressed effectively.

Summary, policy recommendations and suggestions for further research

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

Policies are needed to ensure that audit report usefulness is enhanced and to facilitate substantive dialogue between auditors and shareholders. The UK APB has taken steps towards making audit reports more

informative (APB, 2007) but the research indicates more radical policies may be required. Audit reports should focus much more on risks, uncertainties and other entity-specific matters.

There is also a need for policies to reinstate the relationship between auditors and shareholders not just in legal form but in substance. Further research is needed to determine how best to pursue this issue. Other findings suggest that further research is required prior to the formulation of detailed policy measures. Research should explore whether auditors are able and willing to provide assurance on management commentary, and if so, at what level and scope. This is particularly important given that the prevailing attitude of the auditing profession to assurance on management commentary appears to be cautious. The views of auditors on these issues are currently being investigated in a second stage of this project. Further research on auditor views on the matter, therefore, may have implications for audit education or for the provision of assurance other than by the external audit profession. More generally, research is needed to develop future policy measures aimed at making the external audit a more useful product.

These more general concerns and those specifically focused on management commentary are not mutually exclusive. Providing assurance on management commentary, for example, may make the external audit more useful although without also enhancing audit reports this may be of limited value. Together, the issues highlight both threats and opportunities for external auditors. The recent financial meltdown has again resurrected the perennial question as to what may reasonably be expected from auditors. It may be opportune to reflect, if necessary, radically, on what investors and other stakeholders really want from external assurance in the twenty-first century. Unwillingness by regulators and firms to facilitate more useful assurance arrangements might exacerbate these tensions. More positively, bold policy measures that are responsive to the issues highlighted in this report may result in more valuable external assurance.

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CA House • 21 Haymarket Yards • Edinburgh • EH12 5BH

Tel: 0131 347 0237 • Fax: 0131 347 0114

Email: research@icas.org.uk • Website: www.icas.org.uk/research