AUDITOR COMMUNICATION IN AN EVOLVING ENVIRONMENT: GOING BEYOND SAS 600 AUDITORS' REPORTS ON FINANCIAL STATEMENTS

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In 1993 the Auditing Practices Board issued an expanded audit report, *SAS 600 Auditors' Reports on Financial Statements*, in an attempt to educate users and to clarify certain matters pertaining to the audit function. This paper investigates the extent to which the new audit report, SAS 600, has been successful in aligning the views of auditors, preparers and users about issues dealt with in the expanded audit report, and the extent to which the three groups considered that it would be useful for additional matters, including corporate governance, to be reported upon by the auditor. Our findings suggest that SAS 600 has been successful in clarifying the purpose of the audit and the respective responsibilities of auditors and directors. However, to meet the expectations of users and to add more value, the audit report needs to provide more information about the *findings* of the audit.

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INTRODUCTION

The auditors' reporting environment has significantly changed since the Holt & Moizer (1990) and Hatherly *et al.* (1991) studies found limitations in the short form auditors' report. In the 1990s the content of annual reports of listed companies have become increasingly complex (Bartlett & Chandler, 1997; and ICAEW, 1999) and the audit methodologies of large accounting

The authors are grateful to the ICAEW Centre for Business Performance for funding this research. Thanks are due to Prof David Gwilliam, Prof David Hatherly, Prof Richard Macve and participants at the 2000 British Accounting Association Annual Conference at Exeter and the 2000 Financial Reporting & Business Communication Conference at Cardiff.

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Received October 2000; revised and accepted March 2001

0890-8389/01/020113+24 \$35.00/0

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firms have evolved (Bell *et al.*, 1997; KPMG, 1999; Lemon *et al.*, 2000). During the same period, following criticisms of the accounting profession and of directors, there have also been significant developments in the regulation of auditing (Sherer & Turley, 1997) and in corporate governance (Short *et al.*, 1999) and more recently a revision of company law has been proposed (see PricewaterhouseCoopers, 1999 and Company Law Review Steering Group, 2000). In addition to these there has been a more specific change—the introduction of the expanded audit report, SAS 600 Auditors' Reports on Financial Statements. The Auditing Practices Board introduced SAS 600 in an attempt to educate users and reduce what they perceived as users' misunderstandings in respect of certain matters pertaining to the audit function. The rationale for the change, couched as an attempt to reduce the audit expectations gap, is premised on the assumption that the audit report can be used to educate users about the duties and responsibilities of auditors. Implicit in this is a notion that the beliefs held by users as to the nature of the auditors' duties and responsibilities are incorrect and that if those views can be readjusted to align with those of the profession then the expectations gap will be reduced.

We examine auditor communication in the context of this evolving environment. Our research objectives are to determine: (i) the extent to which auditors, preparers and users of financial statements appear to be satisfied that the expanded audit report successfully communicates certain key issues; (ii) the extent to which the three groups consider that it would be useful for additional matters, including corporate governance, to be reported upon by the auditor; and (iii) whether there are any differences in the perceptions of the three groups. Our paper does not examine other changes, for example in respect of auditors' duties, which the Auditing Practices Board has introduced. Issues relating to auditor independence, the meaning of a true and fair view, auditors' responsibilities in respect of fraud and irregularities are important aspects of the expectations gap. They are not, however, central to the concerns of our paper.

The remainder of this paper is structured as follows. In the next section we review previous literature focusing on the limitations of the short form audit report and the profession's response to concerns about the report. The review also includes a discussion of the rationale for the introduction of SAS 600 and prior studies on expanded audit reports. In the third section we describe the research questions and method and in the fourth section we present and discuss our findings. The final section contains our concluding remarks.

BACKGROUND AND PRIOR RESEARCH

Financial reporting is seen as an important process by which companies and other entities report their financial performance during the period

and show their financial position at the end of a particular period. This reporting is considered to be necessary for the efficient allocation of capital and also to demonstrate the stewardship of the directors to the owners of companies (see Gwilliam, 1987). Since the financial reports are generally prepared by individuals who are implicated in the performance of the entity there is reason to believe that they may be motivated to present a picture of the entity that is in line with their self-interest rather than those of the shareholders or other users of the financial reports. Because of the possibility of misstatement of the financial reports, it is common practice to have the reports audited by some independent body. Although in the 1800s a member of the shareholding group might have audited the financial statements of companies, it is the practice nowadays for that task to be performed by professional firms of accountants (Carmichael & Winters, 1982).

An essential part of audit practice required to close the circle between the directors and the owners is for the auditors to report the findings of their audit to shareholders. The reporting of audit findings normally takes place in a number of ways. Firstly, during and after the audit the auditors are likely to discuss with senior managers and directors of the company any issues arising from the audit. Secondly, after completing the audit the auditors will send a letter, the management letter, to the directors of the company setting out any findings arising from the audit. Typically, these findings will include—pointing out deficiencies in the companies' internal control system and more generally—commercial advice that might improve the running of the company (Manson *et al.*, 1994). The purpose of these letters is to provide the directors with advice that, if implemented, the auditors consider is likely to be beneficial to the company and hence to its shareholders. Even though the implementation of the content of these letters is likely to benefit shareholders, they do not see the letters but instead rely on the more institutionalized or standardized form of reporting done via the audit report included with the financial statements. The substantive part of the audit report is a concise statement by the auditors that the financial statements give a true and fair view and comply with the appropriate legislation, usually the Companies Act 1985. If, for some reason, the auditors consider that the financial statements do not give a true and fair view or do not comply with some legislative requirement then they are usually required to report that fact via what is known as a qualified audit report. Since the audit is a complex, costly and time consuming process it might be thought that any report to shareholders would include a substantive amount of text incorporating issues discussed with management or included in the management letter. The omission of any discussion of the findings of the audit in the present audit report might lead one to question if the audit report is as valuable as it could be.

The 1980s saw increasing criticism of the performance of auditors. In particular, commentators highlighted the failure of auditors to detect major

frauds or signal that the auditees were in financial difficulty. These debates crystallized around what is known as the expectations gap, that is, the gap between what auditors perceive are their duties and responsibilities and what the public believes (see Humphrey *et al.*, 1992; Mills & Bettner, 1992; Sikka *et al.*, 1992; McInnes, 1993; Porter, 1993; APB, 1994 and Humphrey, 1997). Some academic critics, for example Sikka *et al.* (1992), have argued that the expectations gap is endemic because auditing is a social activity, and as with all such activities, its precise meaning is likely to be contested and cannot be fixed. The inevitable conclusion arising from this perspective is that the expectations gap cannot be eliminated. A more general point made by critics is that the audit profession has been rather negative in their response to criticisms. For example, Humphrey *et al.* (1992) state that the response of the auditing profession seems to be to give readers more information about auditing, rather than more information about the results of the audit. The profession has responded to the criticisms by claiming that the misunderstanding have arisen primarily because of ineffective communication between auditors and users of the audit report.

Criticisms about the audit report are not confined to the UK. In the US an early indication of concerns about the effectiveness of the audit report as a communication device was contained in the report of the Cohen Commission (1978). The report highlighted shortcomings in the short form audit report as a means of communication between auditors and users. In particular it stated, 'the auditor's role and responsibilities have expanded and will continue to expand. An auditor's report on a set of financial statements, as now presented, is not sufficient to convey his role and responsibilities as they now exist or as they will evolve in the future. A report on the entire function is required to provide sufficient flexibility to convey the required information to users' (p. 75). In the UK a similar view was reached in the *Report of the Working Party on the Future of the Audit* (ICAEW, 1986). The report stated that concern had been raised about the brevity of the short form report, the lack of any comment on the auditor's responsibilities, and the use of technical language that may be misunderstood. The report concluded that the 'audit report should be constructed and worded in such a manner which makes it easier and clearer for the non-expert to understand it, which avoids ambiguity and which contains as few "coded" statements as possible' (p. 18). The recommendations of the Working Party were taken forward by the Auditing Practices Board in the publication of a Consultative Paper, '*Proposals for an Expanded Audit Report*' (APB, 1991). This was the first stage in the process of issuing the new standard SAS 600 Auditors' Reports on Financial Statements.

Prior to the issuing of SAS 600 in the UK, the US Auditing Standards Board had issued an auditing standard SAS 58 (AICPA, 1988) that introduced the expanded audit report in the US. The aim of the new US standard was to increase user understanding and to improve communications between auditors and users in respect of the auditors'

work and their responsibilities—an attempt to narrow the expectations gap. A number of US based studies, (for example, Kelly & Mohrweis, 1989 and Miller *et al.*, 1993) have attempted to determine if users' perceptions of auditors' responsibilities and the nature of the audit has been affected by the introduction of SAS 58. Kelly & Mohrweis (1989) conducted a questionnaire survey of investors and bankers¹ to identify if the form of the audit report influenced their understanding and perceptions of who was responsible for the financial statements. They found that both investors and bankers perceived the expanded audit report to be more understandable than the short form report. The form of the audit report did not, however, appear to influence investors' perceptions of the responsibility of auditors although the bankers group perceived the expanded audit report conveyed that auditors were assuming less responsibility. Miller *et al.* (1993) carried out a survey of bank loan officers designed to test their perception of a number of issues relating to an unqualified audit report. The authors divided the bankers into two groups, one group was given the old short form report and the other was given the new expanded report. Based on the loan officers' responses to a number of questions on the respective audit reports the authors concluded that the expanded audit report, SAS 58, resulted in an improvement in the ability of bankers to identify the responsibilities of auditors and management for the financial statements. Similar results to the above, within an Australian context, were found in a study by Gay & Schelluch (1993). In general, the non-UK evidence presents a favourable impression of the expanded audit report's ability to better communicate some of its intended messages than the short form report.

In the UK Holt & Moizer (1990) noted the limitations of the short form audit report and Hatherly *et al.* (1991) investigated the impact of the expanded audit report on the perceptions of users as proxied by part-time MBA students at the University of Edinburgh. Since Hatherly *et al.* (1991) conducted their study prior to the introduction of SAS 600 they used a variant of the US expanded audit report as an example of an expanded audit report. The results of their experimental study provided evidence of the ability of an expanded audit report to change reader perceptions. In a related paper Innes *et al.* (1997) compared the perceptions of Scottish Chartered Accountants with that of the MBA students and found that the expanded audit report (when compared to the short form report) brought users' perceptions, to some extent, closer into alignment with those of auditors. They also found, however, that along a number of different dimensions users' perceptions were still significantly different from those of auditors. This can be interpreted as indicating that whilst the expanded audit report might reduce the expectations gap it is unlikely to eliminate it. Interestingly, they also found that the expanded audit report seemed to increase users' perceptions of the usefulness of the financial statements. In particular, they found that the expanded audit seemed to increase users' perceptions that the financial statements were free from fraud.² Innes *et al.* (1997) concluded by

stating that they considered 'the expanded audit report to have a useful but limited impact on the expectations gap and to give a patchy performance in terms of moving users' perceptions towards those of auditors' (p. 714). As an alternative to standardized reporting Hatherly (1997) and Hatherly *et al.* (1998) suggested that the process of communication via the report could be improved by auditors using 'free-form' reporting rather than standardized reporting.

Our study is related to but different from the UK studies of Holt & Moizer (1990) and Hatherly *et al.* (1991, 1998). First, whereas the Holt & Moizer study was based on the old short form audit report and Hatherly *et al.* (1991) was based on a derivative of the US expanded audit report, our study is based on the actual standard, SAS 600. Second, Hatherly *et al.* (1991, 1998) was an experimental study and used MBA students as surrogates for users. In our empirical study the user group consists of investment analysts and corporate bankers and we also survey auditors and preparers. Third, dimensions such as fraud and error which are not covered by Hatherly *et al.* (1991) are included in our study. Fourth, as well as examining the message conveyed by SAS 600, in this study we investigate the extent to which auditors, preparers and users consider that it would be useful for additional matters, including corporate governance, to be reported upon by the auditor. This paper, thus, not only takes into account developments in the auditors' reporting environment but also extends prior UK research on audit reports.

INTRODUCTION OF SAS 600

In October 1991, the Auditing Practices Board published its proposals for an expanded auditors' report in a Consultative Paper. This was the first stage in the process of issuing a new auditing standard, SAS 600 Auditors' Reports on Financial Statements. In the Consultative Paper the Auditing Practices Board discussed the expectations gap and outlined the potential for an expanded audit report to reduce such a gap. In the Auditing Practices Board's opinion there were misunderstandings: of the nature of audited financial statements; as to the type and extent of work undertaken by auditors; and about the level of assurance provided by auditors (APB, 1991, para. 8). The Auditing Practices Board proposed that these aspects of the expectation gap could be addressed by an expanded audit report that set out (i) the obligations placed on the preparers of the financial statements; (ii) the main features of the fundamental accounting concepts underlying the preparation of financial statements; and (iii) the duties of the auditors in relation to the financial statements and the principal features of the process by which they discharge that responsibility (APB, 1991, para. 14).

The Auditing Practices Board believed that:

'The expansion of the auditors' report [to include such information as statements describing the respective responsibilities of directors and of

auditors, and a description of the key features of an audit] could play an important part in improving the communication between auditors and members of the public who read financial statements, and so could start to narrow the so-called “expectations gap” (APB, 1991, para. 3).

Because of this belief, the Auditing Practices Board specifically asked for comments relating to the proposals to expand the audit report and the potential for the suggested additional text to reduce the expectations gap. Finally, there was explicit acknowledgement that expanding the audit report would not deal with all the issues giving rise to the expectations gap. For this reason the Auditing Practices Board intended: ‘To address separately the question of revising existing auditing guidance on operational matters in order *to deal with other expectation gap issues*’ (APB, 1991, para. 9, our emphasis). It also proposed that any change in the standard auditors’ report should be accompanied by the release of a booklet explaining at greater length the meaning of the auditors’ report and the scope of work required to express an audit opinion.

After allowing time for responses to the Consultative Paper the Auditing Practices Board issued an exposure draft in May 1992. The main emphasis in the exposure draft (APB, 1992) was on proposed changes to the nature of qualified audit reports with very little discussion on the issue of the expectation gap. Subsequently, the Auditing Practices Board issued a new standard, SAS 600 Auditors’ Reports on Financial Statements (APB, 1993) in May 1993. This standard was similar to SAS 58 issued in the USA (AICPA, 1988) in moving away from a short form audit report to an expanded audit report.³ In both cases the wording of the standards included descriptions of the auditors’ work and the respective responsibilities of the auditors and the directors. The rationale for the change was couched in terms of attempting to reduce the audit expectations gap. The validity of this explanation is dependent on the assumption that the audit report can be used to educate users about the duties and responsibilities of auditors. It should also be pointed out that the Auditing Practices Board appears to take it for granted that the beliefs held by users as to the nature of the auditors’ duties and responsibilities are incorrect and that if those views can be readjusted to align with those of the profession then the expectations gap will be reduced.

RESEARCH OBJECTIVES AND METHODS

Set against the evolving context of the auditors’ reporting environment our research objectives are to determine: (i) the extent to which the three groups surveyed, auditors, preparers and users, appear to be satisfied that the expanded audit report successfully communicates certain key issues; (ii) the extent to which the three groups consider that it would be useful for additional matters, including corporate governance, to be reported upon by

the auditor; and (iii) whether there are any differences in the perceptions of the three groups.

Our paper is based on a questionnaire survey sent to a number of individuals from the three groups: auditors, preparers and users. The questionnaire consisted mainly of questions requiring a response on a seven point likert scale and were designed to determine respondents' views in respect of certain key issues relating to changes in the wording of the expanded audit report. The questionnaire included as an appendix a sample auditors' report taken from SAS 600 to which respondents were referred. Since SAS 600 was replacing an existing standard on audit reports it might have been useful to make a comparison of views of respondents on both the old and the new auditing standard. We discounted this approach for two reasons. First, the new audit report had been in existence for six years at the time of the study and we doubted whether respondents would be able to cast their mind back to the time when the previous audit report had been in use and therefore considered that any responses might be unreliable. Second, our objective was to determine what respondents thought about the wording used in SAS 600, rather than being a comparison with the previous audit report standard, and to identify areas where the scope of the audit report could be expanded.

The questionnaire was sent to the three groups in 1999 and where no response was received a follow up letter was sent approximately two months after the original request. Where a questionnaire was returned uncompleted because the addressee was not at the address to which the questionnaire was sent another individual was selected. Details of the questionnaires sent and respective responses for the three groups are given in Table 1.

The auditor sample was selected from the 1999 ICAEW Directory and included audit partners in: Big 5, Top 40 (excluding Big 5) and other firms. Audit partners were only selected from audit firms that were designated as being involved in audit work. It is recognized that there are auditors holding other qualifications, such as, ACCA, ICAS or ICAI who are involved in audit work but we considered that using only the ICAEW register was not likely to impart any specific bias. We chose individuals who were designated as partners in the audit firms because they are ultimately the individuals who are responsible for the audit report and were likely to have the necessary experience to reliably complete the questionnaire.⁴

TABLE 1

Questionnaire survey response rates

	Auditors	Preparers	Users	Total
Mailed	400	400	200	1000
Usable Responses	163	118	45	326
Response Rate	41%	30%	23%	33%

The sample of finance directors was selected from three groups of companies: quoted companies, large unquoted companies and small unquoted companies. The source of the quoted companies was the Stock Exchange Year Book from which we selected 200 UK registered companies. The unquoted companies sample was randomly selected from the two volumes of the MacMillan Directory of Unquoted Companies. The first volume lists companies with a turnover in excess of £13 million and we selected 150 parent companies from this group. The other volume lists companies with a turnover of less than £13 million and we selected 50 parent companies from this group. Where we were able to obtain from the directories a named finance director we sent the questionnaire to that person, otherwise the questionnaire was simply addressed to the finance director. Since the number of unquoted companies in the UK far exceeds the number of quoted companies our sample sizes are not entirely representative of the underlying populations. We would, however, argue that the economic importance of the quoted group and the use of their annual reports by a far greater number of users justify our sample selection policy.

The user group sample comprised investment analysts and corporate bankers. Although it may have been useful to select a random sample of non-professional investors, it is difficult to identify a suitable source from which to select an appropriate sample. We recognize, however, that if it is argued that the lay public are important particularly in respect of criticisms related to the expectations gap then our research will not provide any guidance on whether the expanded audit report has helped in reducing the expectations gap pertaining to them. A counter-argument is that the efficient markets hypothesis suggests that the existence of a sufficient number of sophisticated investors results in naive investors being price protected.⁵ Therefore, from an investment perspective whether naive or lay investors fully comprehend all of the information contained in the annual report is relatively unimportant. Furthermore, prior research by Humphrey *et al.* (1993) and Porter (1993) suggest that there is an expectations gap among educated users. It would not seem unreasonable to first investigate whether sophisticated users perceptions have moved more into alignment with those of auditors before examining the effect of the expanded audit report on naive investors.

RESULTS

This section presents and discusses our survey findings. It is divided into two parts: the first part is concerned with the effectiveness of the message conveyed by SAS 600 Auditors' Reports on Financial Statements and the second part is concerned with the extent to which auditors, preparers and users believe that it would be useful for additional matters, including corporate governance, to be reported upon by the auditor.

Meaning of SAS 600

General The first three questions in Table 2 were designed to elicit the three groups perceptions on certain general aspects pertaining to the audit report. The results for question 1 suggest that all three groups agree that the inclusion of an audit report enhances the credibility of the financial statements. While this result is not unexpected, it does support the view that the audit is valued. The mean response for question 2 indicates no significant difference between the three groups with the general consensus being that the purpose of the audit is reasonably well spelt out in the audit report. The lack of any significant difference between the groups is indirect evidence that the Auditing Practices Board has been successful in using the audit report as a vehicle to communicate the purpose of the audit. This might suggest that part of the expectations gap has been eliminated, it should be recognized that although users and directors may agree that the purpose of the audit has been adequately communicated they might not agree that the stated purpose is appropriate. If users believe that the purpose of the audit should go beyond what is stated in the audit report then the expectations gap will remain. It is also appropriate to emphasize that the responses only suggest that the wording used to convey the purpose of an audit as stated in the example of the expanded audit report we provided with the questionnaire is considered by respondents to clearly communicate the purpose of an audit. We acknowledge, however, that it is possible two individuals reading the purpose as stated in the audit report may interpret it in different ways.

The response to question 3 suggests there is qualified support for the notion that the audit report is a readable document. It is interesting that the user group believes the audit report is more readable than the auditor group.

TABLE 2

General

Question	Mean Score <1=strongly agree ... strongly disagree=7>		
	Auditors	Directors	Users
1: How strongly do you agree that the inclusion of an audit report enhances the <i>credibility</i> of financial statements?	1.80	1.96	1.91
2: How strongly do you agree that the <i>purpose</i> of the audit is clearly communicated in the audit report?	2.71	2.79	2.49
3: How strongly do you agree that the audit report is a <i>readable</i> document?	3.49*	3.49	3.09*

*Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the user group was significant at the 10% level.

This would appear to be slightly contrary to the accepted wisdom that the audit report is a technical document only comprehensible to knowledgeable individuals. However, it can be argued that although users may consider the audit report to be readable they do not appreciate the technical nature of its contents.

Nature of auditors' work One of the explanations often offered by the profession for the existence of the expectations gap is lack of understanding by users and other groups as to the nature of the audit and of the work carried out by the auditors. In the expanded audit report the Auditing Practices Board tried to remedy this situation by including text in the audit report about the auditors' work. Questions 4 and 5 in the questionnaire attempted to measure how successful the wording used by the Auditing Practices Board was in informing the three groups about the nature of the auditors' work.

The scores for question 4 would appear to indicate a certain level of neutrality about whether the audit report effectively summarizes the extent and nature of evidence gathered by auditors. There is no significant difference between the three groups. The response by the auditor group should be of particular concern to the Auditing Practices Board since it seems to indicate that even they do not consider the wording as being successful in conveying its intended message, ie clearly summarizing the extent and nature of evidence gathered in the formation of the opinion. The response to question 5 is slightly more positive in that all three groups appear to consider that the wording used in the audit report does give some indication of the role of judgement in the formation of the audit opinion. Overall, the responses to these two questions are somewhat disappointing. They suggest that the additional text which is included in SAS 600 is not considered by the three groups as being particularly successful in an educative role. Thus, it might be argued that the audit report needs to

TABLE 3

Nature of auditors' work

Question	Mean Score <1=strongly agree ... strongly disagree=7>		
	Auditors	Directors	Users
4: How strongly do you agree that the audit report clearly summarizes the extent and nature of the <i>evidence</i> gathered in the formation of the audit opinion?	4.09	4.09	3.84
5: How strongly do you agree that the audit report clearly indicates the role of <i>judgement</i> in the formation of the audit opinion?	3.56	3.54	3.69

include further, clear information about the evidence gathered by auditors and the role of judgement in the formation of the audit opinion.

Extent of auditors' responsibilities Another factor considered a prime source of the expectations gap is users' lack of knowledge about the auditors' responsibilities for the detection of fraud and error. In an attempt to remedy this situation, the Auditing Practices Board recommended that the audit report should contain some text outlining the auditors' duties.

The responses to question 6 suggest that the wording used in the audit report is not considered by the respondents to clearly indicate the auditors' responsibility for the detection of fraud. Prior to the issue of SAS 600 two members of staff from Touche Ross had written in *Accountancy* (Jones & Lim, 1992) that they did not consider enough emphasis had been placed on the limitations of the audit process with particular reference to collusive or immaterial fraud. The responses to question 6 can be seen, at least partly, as supporting the above authors' concern about the wording used in relation to the auditors' responsibility for fraud.

The mean values for question 7 indicate that the respondents did not consider the wording in the expanded audit report was successful in conveying the auditors' responsibility in relation to illegal acts. It is interesting that of the three groups the auditor group had the highest mean score, being significantly different from the mean score of the other two groups. This can be interpreted as indicating that auditors believe the audit report wording could be improved to outline the auditors' responsibility in relation to illegal acts more successfully. The present wording in the Basis of Opinion section of the sample Auditors' Report states 'the financial statements are free from material misstatements, whether caused by fraud

TABLE 4

Extent of auditors' responsibilities

Question	Mean Score <1=strongly agree ... strongly disagree=7>		
	Auditors	Directors	Users
6: How strongly do you agree that the auditors' responsibility in relation to <i>fraud</i> is clearly indicated in the audit report?	4.34**	3.92**	3.98
7: How strongly do you agree that the auditors' responsibility in relation to any <i>illegal</i> acts performed by the client is clearly indicated in the audit report?	4.91* **	4.30**	4.36*

*Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the user group was significant at the 10% level.

**Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the director group was significant at the 5% level for question 6 and at the 1% level for question 7.

or *other irregularity* or error' (emphasis added). It is possible that the term 'other irregularity' is not explicit enough to denote that it encompasses illegal acts.

Extension of the audit report

Going concern and fraud or illegal acts A number of studies have found that among the factors contributing to the expectations gap is the perception that a clean audit report signifies the auditee is a going concern and that the financial statements are free from fraud and error (see Humphrey, 1997). In the process leading to the issuing of SAS 600 a number of respondents to the Consultative Paper acknowledged that going concern and fraud were two of the major contributors to the expectations gap. In light of this some of these respondents suggested that auditors should respond by accepting that they could do more to provide users with assurance about going concern and the possibility of fraud. It should also be acknowledged that the auditor respondents, however, usually coupled the increase in their responsibilities with a requirement that any changes should not leave them open to expensive litigation (Manson & Zaman, 1999).

The results for question 8 clearly indicate that users are particularly keen for the auditors to include a statement in the audit report of their assessment of the going concern status of the client. The response by the directors suggests that they are mildly in favour of the inclusion of

TABLE 5

Going concern and fraud or illegal acts

Question	Mean Score <1=strongly agree ... strongly disagree=7>		
	Auditors	Directors	Users
8: How strongly do you agree that in the future there should be an explicit statement in the audit report of the auditors' assessment of the <i>going concern</i> status of the client?	4.67* **	3.25** ***	2.36* ***
9: How strongly do you agree that in the future there should be an explicit statement in the audit report of the auditors' findings in relation to <i>fraud</i> or <i>illegal acts</i> ?	4.72* **	3.24** ***	2.13* ***

*Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the user group was significant at the 1% level for questions 8 and 9.

**Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the director group was significant at the 1% level for questions 8 and 9.

***Using both a *t*-test and a Mann-Whitney test the difference between the director and the user group was significant at the 1% level for questions 8 and 9.

a statement about going concern in the audit report. Both the user and director groups gave similar responses for question 9. For both questions the auditor group were slightly against the inclusion of a statement about going concern and fraud or illegal acts in the audit report. Taken together, responses to these two questions provide evidence that the user group expects more from auditors in the audit report than auditors seem willing to provide. It is not unexpected that these two issues appear to be important to all three groups. From the perspective of the user group the ability of the entity to remain a going concern is ineluctably linked with the value of their investment. Similarly, the incidence of fraud and or illegal acts may have a significance beyond its mere occurrence because it potentially signals higher risk, poor internal controls, lack of integrity and inadequate attention by directors and senior management in deterring and preventing fraud or illegal acts. From the point of view of the auditor group they are unlikely to want to be explicit about issues which by their nature are difficult to assess and where an incorrect assessment by them might leave them open to litigation. In addition, Singleton-Green (1992) stated that there was concern among audit firms about the practicality of reporting on going concern and the response to question 8 suggests that auditors are still reluctant to report explicitly on going concern. Nevertheless, it would appear that the Auditing Practices Board needs to seriously consider how they can move towards satisfying a demand by the user group by, perhaps, supplying additional information on the two issues while at the same time limiting the potential litigation risk to auditors.

Non-financial information in annual report The Annual Report of most companies is usually a sizeable document containing many items other than the financial statements. Although the audit report specifies the pages in the Annual Report that have been subject to audit there may still remain a certain amount of uncertainty as to whether other information has been subject to scrutiny by the auditor. This is particularly so when other statements in the Annual Report contain financial information. Section 235(3) of the Companies Act 1985 requires auditors to check the consistency of the information included in the Directors' Report with the financial statements subject to audit. Similarly, SAS 160, *Other Information in Documents Containing Audited Financial Statements*, requires that auditors 'should read the other information [and] if as a result they become aware of apparent misstatements therein, or identify any material inconsistencies with the audited financial statements, they should seek to resolve them' (APB, 1995, para. 5). These requirements, however, are not specifically stated anywhere in the Annual Report and therefore it is implicitly assumed that users are aware of their existence.

In response to questions 10a) and d) both users and directors were mildly in favour of the auditors stating the extent of their examination of the Chairman's Statement and other information included in the Annual

TABLE 6

Non-financial information in annual report

Question	Mean Score <1=strongly agree ... strongly disagree=7>		
	Auditors	Directors	Users
10: How strongly do you agree that it would be useful for the auditor to indicate either in the audit report or in a separate statement, the extent of their examination of:			
a) the Chairman's Statement	4.35* **	3.90**	3.38*
b) the Director's Report	4.01* **	3.54** ***	2.98* ***
c) the Operating and Financial Review	3.87* **	3.32** ***	2.60* ***
d) any other information included in the annual report but outside the financial statements?	4.49* **	3.94** ***	3.42* ***

*Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the user group was significant at the 1% level for questions a), b), c) and d).

**Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the director group was significant at the 5% level for questions a) and b) and at the 1% level for c) and d).

***Using both a *t*-test and a Mann-Whitney test the difference between the director and the user group was significant at the 10% level for questions b) and d) and at the 5% level for c).

Report. In contrast the auditor group were slightly against the inclusion of any statement about the extent of their examination of these two items. It may seem rather surprising that the auditors are slightly unwilling to make any statement even if that statement only amounted to saying that they did not audit the Chairman's Statement or any other information but had read the disclosures with a view to identifying misstatements or inconsistencies. It is possible, however, that auditors consider that by including reference to the page numbers of the Annual Report in the audit report that are subject to their audit opinion they have made sufficiently clear the extent of their duties. The responses to question 10b) have a similar pattern to those of questions 10a) and d) where the user group would like some statement of the extent of the auditors' examination of the Directors' Report but the auditors are slightly less keen to include such a statement. The reluctance of the auditors to include some description of the extent of their examination is somewhat at variance with the fact that the Companies Act specifically provides that they are required to check the content of the Directors' Report is consistent with the figures in the financial statements that are subject to audit. Adding a statement to this effect would merely be reiterating their responsibilities under the Companies Act rather than adding anything to their responsibilities.

In July 1993 the Accounting Standards Board recommended that listed companies should include in their annual report an Operating and Financial Review which includes a discussion and interpretation of the business, the main factors, features, as well as uncertainties that underlie it and the structure of its financing (ASB, 1993). There is some evidence the Operating and Financial Review has become an important part of the financial information disclosed in the Annual Report and is regarded as one of the Accounting Standard Board's most successful innovations (see Davies *et al.*, 1999 and Weetman, 2000). The Accounting Standards Board did not believe it was necessary, however, for its content to be audited. Recently the Company Law Review Steering Group (2000) recommended that listed companies should include a new expanded Operating and Financial Review. Furthermore, they recommended that auditors should review such an Operating and Financial Review for: consistency with financial and other records; factual accuracy; compliance with applicable accounting standards and consistency with the auditors' knowledge of the company (para 5.98). The suggestion of the Company Law Review Steering Group would appear to be supported by the mean score for question 10c) for the user group. The mean score for the auditor group although approximating a neutral response to this question is significantly different from those of the director and user groups. In general, the responses to question 10 indicates that users would like additional information and for the auditor to state the extent of their examination of that information.

Internal control and materiality Since the publication of the Cadbury Committee report in 1992 there has been considerable discussion of the need for disclosures about a company's internal control system. The importance attached in many quarters to internal control is an acknowledgement of its link with such issues as the safeguarding of a company's assets and also more generally as an indicator of how competently the company is being managed. It is likely that added impetus was given to the debates about the need for disclosures about internal control by well-publicized scandals, such as, Barings Bank, that highlighted the costly consequences of deficiencies in internal controls. The Cadbury Committee (1992) recommended directors should report on the effectiveness of a company's internal financial control system and that the auditors should review the directors' statement. Subsequent to the issuing of the Cadbury Report there was considerable debate about the feasibility of directors measuring and reporting on the effectiveness of internal controls. In addition, auditors were reluctant to commit themselves on an issue that was subject to uncertainty and could possibly lead to them being sued where ineffective internal controls contributed to losses by shareholders or other parties. Subsequently, the Hampel Committee (1998) changed the requirement relating to internal control and instead required that directors should review the effectiveness of a group's system of internal controls and report to shareholders that they

have done this. Thus, directors do not have to report their assessment of the internal controls but merely state that they have made an assessment (Turnbull, 1999). The auditors' role has been reduced to ensuring that the directors' statement that they have conducted an assessment of the internal controls is accurate. This, however, understates the extent to which auditors may rely on a company's internal control system when undertaking their audit. It is common practice in risk based auditing of large clients for auditors to rely on a company's internal control system and consequently reduce the amount of tests of detail they perform (see Lemon *et al.*, 2000). It is within this context that we asked our three groups the extent to which they would welcome additional disclosures by auditors relating to internal controls.

The mean responses to questions 11a) and b) indicate that the user group is interested in the issue of internal control and in particular the extent to which the auditors have examined and relied upon the internal controls. It is likely the users believe the disclosures would provide them with some impression of risk. For example, if the auditors have not relied on the internal controls this could suggest they did not consider them strong enough to reduce their tests of detail. The response for the auditor group is significantly different from that of the user group and indicates that they do not believe the disclosures would enhance the value of the audit. The

TABLE 7

Internal control and materiality

Question	Mean Score <1=strongly agree ... strongly disagree=7>		
	Auditors	Directors	Users
11: How strongly do you agree that the value of the audit would be enhanced if the auditor reported, either in the audit report or in a separate statement, in respect of each audit engagement:			
a) the scope of their study of the client's internal controls	4.57* **	3.85** ***	2.64* ***
b) the extent to which they relied on the internal controls	4.70* **	3.61** ***	2.49* ***
c) the materiality level they used?	4.99* **	3.77** ***	2.80* ***

*Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the user group was significant at the 1% level for questions a), b) and c).

**Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the director group was significant at the 1% level for questions a), b) and c)

***Using both a *t*-test and a Mann-Whitney test the difference between the director and the user group was significant at the 1% level for questions a), b) and c).

mean score for the auditor group could indicate that they consider such disclosures might increase the likelihood of litigation because users may read more into them than is justified. Alternatively, auditors may believe that users are insufficiently familiar with the practice of auditing to fully understand the nature and potential limitations of the disclosures. The response for the director group fell in between that of the other two groups and indicates that they believe the disclosures would slightly enhance the value of the audit.

When undertaking their audit work and giving their report auditors do so within the context of materiality. For example, when the auditors give an opinion they are not saying that the financial statements are free of all fraud and error, only it is their opinion that there is no material fraud and error in the statements. Disclosure of the materiality level might provide guidance to users of the extent to which the financial statements could potentially be misstated. Another way of viewing this is to suggest it provides the quantitative context in which the auditors have arrived at their opinion that the financial statements give a true and fair view. The pattern of mean responses to question 11c) is similar to that of 11a) and 11b). Users believe such disclosures would be useful whereas the auditor group believe they would not be useful in enhancing the value of the audit. The difference between the two groups is significant. As with questions 11a) and b) the mean value of the response of the director group is between the other two groups and indicates a certain level of neutrality to this disclosure. There are a number of possible reasons why the auditor group do not believe disclosure of their materiality level would enhance the value of the audit. First, they may regard the materiality level as sensitive information that they do not wish to be known to users, directors or management in their clients. Second, they might regard a quantitative assessment of materiality as too crude a measure of their judgmental process as to whether an item in the financial statements is material or not and, as such, could potentially mislead users. Finally, additional disclosures such as this might be seen to remove some of the mystique surrounding the audit process with a disclosure in quantitative terms perhaps, suggesting that an audit is more mechanistic than audit practitioners proclaim.

Issues arising during the audit Traditionally at the end of an audit the company will be sent a management letter by their auditors outlining any issues arising during the audit and also containing advice about how the company could, for example, improve its systems. This letter is usually sent to the board of directors of a company and its content is not divulged to shareholders or any other interest group. Thus, although the auditors legally act on behalf of the shareholders they receive very little in the way of communication or explanation from the auditors. This perspective is at odds with the generally held view that information is a valuable commodity in decision making. It can be argued that the onus should be on the profession

TABLE 8

Issues arising during the audit

Question	Mean Score <1=strongly agree ... strongly disagree=7>		
	Auditors	Directors	Users
12: How strongly do you agree that the value of the audit would be enhanced if, for each audit, the report explained the most difficult issues arising in the audit and how they had been resolved?	5.18* **	4.68** ***	3.29* ***

*Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the user group was significant at the 1% level.

**Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the director group was significant at the 5% level.

***Using both a *t*-test and a Mann-Whitney test the difference between the director and the user group was significant at the 1% level.

to demonstrate that additional disclosure of issues arising during the audit and other similar disclosures would not be of benefit to users.

In response to question 12 the mean value for the user group indicates that they believe the value of the audit would be slightly enhanced by this disclosure. In contrast the mean value for the auditor group suggests that they do not believe the disclosure would enhance the value of the audit. The difference between the means of these two groups was statistically significant. The response from the director group indicates that they were not convinced the disclosure would enhance the value of the audit. Their disagreement with the statement was, however, not as strong as that of the auditor group. The response to this question provides additional evidence that the auditor group is unwilling to provide additional information about the results of their audit and their responses stand in contrast to that of the user group who indicated a preference for additional information.

Corporate governance Since the adoption of the Cadbury Committee recommendations by the London Stock Exchange the directors of listed companies have been required to state whether or not they have complied with the provisions in the Cadbury Committee Code of Best Practice. This requirement was augmented by the requirements contained in the Hampel Committee Report (1998). The role of the auditor in respect of the directors' statement on corporate governance has been to check that certain disclosures in the statement are consistent with their knowledge of the company. They are not required to report on the corporate governance statement but instead have to review whether the directors' corporate governance statement complies with certain provisions of the Combined Code⁶ and report if it does not.

TABLE 9

Corporate governance

Question	Mean Score <1=strongly agree ... strongly disagree=7>		
	Auditors	Directors	Users
13: How strongly do you agree that an auditor should <i>always</i> report on corporate governance issues for which they have a responsibility?	3.13	3.03	3.47
14: How strongly do you agree that the directors' statement in respect of corporate governance is useful?	3.46* **	3.77** ***	2.47* ***

*Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the user group for question 14 was significant at the 1% level.

**Using both a *t*-test and a Mann-Whitney test the difference between the auditor and the director group for question 14 was significant at the 10% level.

***Using both a *t*-test and a Mann-Whitney test the difference between the director and user group for question 14 was significant at the 1% level.

The responses to question 13 suggest that all three groups agree that the auditor should always report on corporate governance issues. In respect of question 14 all three groups believe the corporate governance statement is useful. It is interesting that the mean score for the user group is significantly different from the other two groups indicating that they are the group who are most convinced about the usefulness of the statement on corporate governance. It is also of some interest that the director group who actually make the corporate governance statement are the group who are least supportive of the statement in question 14.

SUMMARY & CONCLUSIONS

This paper examines: (i) the extent to which auditors, preparers and users of financial statements appear to be satisfied that the expanded audit report successfully communicates certain key issues; (ii) the extent to which the three groups consider that it would be useful for additional matters, including corporate governance, to be reported upon by the auditor; and (iii) whether there are any differences in the perceptions of the three groups. In our survey all three groups believed that the inclusion of an audit report enhanced the credibility of financial statements, that SAS 600 is a readable document and that it clearly communicates the purpose of the audit. On the question relating to the nature of the auditors' work, the responses indicate a certain level of neutrality about whether the audit report effectively summarizes the extent and nature of evidence gathered by

auditors. All three groups considered that the wording used in SAS 600 does give some indication of the role of judgement in the formation of the audit opinion. Overall, the responses to the questions about the nature of the auditors' work is somewhat disappointing in that the inclusion of additional text in SAS 600 is not considered by the three groups as being particularly successful. Similarly, respondents did not consider that the wording in SAS 600 was successful in conveying the auditors' responsibility in relation to fraud or illegal acts.

Interestingly, our survey reveals significant differences in respondents' views concerning extension of the audit report. Users are particularly keen for there to be an explicit statement, in the audit report, of the auditors' assessment of the going concern status of the company and of the auditors' findings in relation to fraud or illegal acts. Directors are also mildly in favour of this, however auditors are slightly against the inclusion of such statements. Likewise, both users and directors consider that it would be useful if the auditor indicated either in the audit report or in a separate statement the extent of their examination of the Directors' Report and the Operating and Financial Review, but auditors are somewhat reluctant to do so. Given the importance of internal controls we asked respondents if the value of the audit report would be enhanced if the auditors reported the scope of their study of the client's internal controls, the extent to which they relied on internal controls and the materiality level they used. Users, in contrast to the auditors, believe that such disclosure would be useful in enhancing the value of the audit. The response to the question about reporting on issues arising during the audit provides further evidence that auditors are unwilling to provide additional information about the results of their audit and their responses stand in contrast to those of users who indicated a preference for additional information. On the issue of corporate governance all three groups agree that auditors should always report on corporate governance issues for which they have a responsibility and believe that the directors' statement in respect of corporate governance is useful. It is interesting, however, that the mean score for the user group is significantly different from the other two groups and that the directors, who actually make the statement, are neutral about the usefulness of the statement.

Overall, our findings suggest that SAS 600 has been successful in clarifying the purpose of the audit and respective responsibilities of auditors and directors. In other respects, for example, conveying the auditors' responsibility in relation to fraud the expanded audit report has been less successful. It is also apparent that auditors remain reluctant to substantively go beyond their present commitment to expressing an opinion on the financial statements. It can be argued that the audit report is of limited value to users and that it needs to be extended to include information about the results of the audit. It is notable that while there have been significant developments in audit methodologies of accounting firms there has been no similar development in the communication of audit *findings* to users.

The challenge for the Auditing Practices Board is to move forward towards providing more information to users about the findings of the audit.

Our paper does have some limitations. Our empirical evidence is based on a questionnaire survey and therefore may not capture the richness of the respondent's views that might be obtained from using an alternative research method. However, we would argue that the research method was appropriate in providing insight into the research questions posed in the paper. Our study does not compare SAS 600 with the previous short form report it replaced and we have not surveyed the views of lay the public. Future researchers may feel it useful to address such shortcomings. We, however, believe that future research can make a more valuable contribution by examining how reporting of audit *findings* can be developed in the context of both current proposals for a revision of company law and recent developments in corporate governance including the increasing emphasis on risk management and internal controls and the predominance of audit committees in listed companies.

NOTES

1. The bankers consisted of employees who had significant commercial lending experience. The investor group consisted of students from a US graduate business programme who had invested in securities.
2. It should, however, be noted that the example they used in their study of an expanded audit report did not include any reference to fraud whereas SAS 600 explicitly refers to fraud or other irregularity or error in the basis of opinion part of the audit report.
3. See Porter & Kedsle (1994) for an international comparison of auditing standards.
4. Our sample included individuals from different offices of the same audit firm. In some instances we received multiple responses from both individual firms and individual offices.
5. It is acknowledged that there is considerable debate about whether stock markets are efficient. Readers are referred to Shleifer (2000) for a discussion of the evidence that suggests markets may not be efficient.
6. The Combined Code, which has been incorporated into the Listing Rules of the London Stock Exchange, consolidates the Cadbury, Greenbury and Hampel Reports and contains a number of provisions that directors are required to address in their statement of corporate governance. Auditors are only required to review 7 of the code's 45 provisions.

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