FAIR, BALANCED AND UNDERSTANDABLE: ENHANCING CORPORATE REPORTING AND ASSURANCE?

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CONTENTS

FOREWORD

Effective corporate reporting is essential to the efficiency of the capital markets but in recent years there have been significant concerns as to whether corporate reporting and the current levels of assurance are meeting the needs of investors. Various initiatives in corporate reporting have resulted in the 'front-half' of annual reports gaining greater prominence than has traditionally been the case – including the need for the annual report as a whole 'to tell the story'. However, it remains the case that it is only the conventional financial statements (the 'back-half' of the annual report) that currently receive a 'true and fair' audit opinion.

In order to address this apparent dichotomy, ICAS commenced a programme of work investigating the scope of assurance on the narrative elements of the annual report. This resulted in the publication in 2010 of research by Fraser and Pierpoint on users' views on external assurance and management commentary, and in 2011 of further research by Fraser *et al.* on auditors' views thereon. This research was used to inform the work of an ICAS working party, and culminated in a number of ICAS publications including *The Future of Assurance* and *Balanced and Reasonable*.

This new research is the next stage in that programme of work and was commissioned to investigate the impact of the fair, balanced and understandable (FBU) requirement – introduced by the UK FRC in 2012 into the UK Corporate Governance Code – on both corporate reporting and assurance and to consider whether it is feasible and desirable to upgrade the assurance provided on the 'front-half' from an exception-based to a positive opinion.

The research finds that the impact of FBU on corporate reporting is viewed positively by preparers and auditors. However, whilst its impact on 'front-half' content is perceived as relatively modest, the impact of FBU on the presentation of content and on the extent to which the annual report presents a cohesive 'story' is viewed as significant. In many cases, the requirement is also perceived to have resulted in a more conscious and reflective process for considering whether annual reports are FBU.

Whilst FBU is largely viewed as one concept, the research finds that there are differing views as to the extent to which its three elements are distinguishable. The concepts of 'fair' and 'balanced', though different, are interlinked: an annual report cannot be fair if it is not balanced. It is not surprising, therefore, that the

two concepts are not always seen as distinguishable. 'Understandable' is the element presenting the greatest interpretive challenge, although it seems clear that whilst an outsider can form a view on whether the annual report and accounts is understandable, only the board, management and the auditor can judge fairness and balance.

Whilst to some the assurance provided on the FBU was greater than that previously provided under the old 'consistency' requirement, to others the level of assurance work undertaken had not changed. There was no clear consensus on the demand for 'positive' assurance and further investigation of demand from investors, is therefore required.

The Research Committee of ICAS has been pleased to support this project. The Committee recognises that the views expressed do not necessarily represent those of ICAS itself, but hopes that the results of this research will be useful to financial reporting stakeholders and provide evidence and challenge for the evolution of both corporate reporting and assurance in the UK and internationally.

Allister Wilson
Convener of ICAS Research Committee
January 2016

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EXECUTIVE SUMMARY

Background

The recent requirement by the UK Financial Reporting Council (FRC) for corporate boards to confirm that their annual reports are 'fair, balanced and understandable' (FBU), and for external auditors to report by exception on this confirmation, innovates in both corporate and audit reporting. FBU may be viewed as a regulatory response to widespread perceptions of a need to enhance corporate reporting, particularly as accounting and auditing continue to be subject to critical scrutiny in the aftermath of financial and economic crisis. FBU also specifically reflects the growing importance of narrative corporate reporting as, for example, in the issue of an International Accounting Standards Board (IASB) practice statement on management commentary and a trend of an increasing volume of narrative content in the annual reports of major companies. At the same time, academic research suggests that investors and other users are interested in assurance on the 'front-half'[1] of the annual report.

There have been other related regulatory and professional developments, both in the UK and internationally. Within the UK, ICAS has pursued an interest in enhancing both corporate reporting, and the assurance provided on it, through several discussion papers and position statements. A key theme in this ICAS work is the proposal that, for listed companies, the external audit and assurance report should confirm whether the annual report, with the exception of the financial statements themselves, is 'balanced and reasonable'. Thus the scope of the assurance provided on the 'front half' is an open issue.

The FBU initiative, together with related corporate reporting and assurance issues, is the subject of this research report.

Research objectives and approach

The objectives of the research were to:

- Identify the impact of the FRC's 'fair, balanced and understandable' requirement and related regulation, especially the strategic report legislation, on corporate reporting.
- Identify the impact of the FRC's 'fair, balanced and understandable' requirement and related regulation on the work of the external auditor.

- Identify the extent to which it is regarded as feasible and desirable to upgrade the assurance provided on the 'front-half' from an exceptional to a positive opinion.

These objectives give rise to the following six research questions (RQ):

RQ 1 Is FBU considered to be an integrated concept or one of three discrete elements? How do individuals interpret the three elements within FBU?

RQ 2 What is the impact of FBU and other related regulation on corporate reporting, particularly the 'front-half'?

RQ 3 What opinions have been received on FBU and 'front-half' assurance from investors?

RQ 4 What is the perceived scope of the assurance which auditors now provide on the 'front-half'?

RQ 5 How desirable and feasible would it be to upgrade the assurance provided on the 'front-half' to enable the provision of a positive opinion?

RQ 6 How adequate are auditor skills in the context of FBU and other possible changes to assurance?

To address these questions, 28 individual interviews were carried out with three key constituencies; preparers, audit committees and external auditors. The findings from the present research will inform subsequent discussions with investors designed to identify the precise nature of their appetite for 'front-half' assurance. Interviews with investors, therefore, have not been included within this current research stage.

Twenty-seven of the interviews relate to nine case companies, seven from the FTSE 100 and two from the FTSE 250. Three interviews were undertaken for each case company; with, respectively, the financial director or substitute, the audit committee chair or company secretary and the signing audit partner.

The nine companies were the audit clients of five firms, two clients of each Big 4 firm and one client of a large non-Big 4 firm. The 28th interview was with a technical partner of another large non-Big 4 firm.

Key findings

Interpretation of FBU (RQ 1)

- FBU is largely viewed as one concept. There are differing views as to the extent to which its three elements are distinguishable.

- 'Fair' and 'balanced' are not always seen as distinguishable. The inclusion of 'balanced' as a term in regulatory rhetoric is regarded positively.
- 'Understandable' is the element presenting the greatest interpretive challenge.
- Individuals representing a particular company, or the same Big 4 firm, do not generally exhibit a common approach to interpreting FBU.
- Although individuals appear comfortable with their individual FBU interpretations, there may arguably be scope for more regulatory guidance in order to encourage a more uniform approach to interpretation.

FBU: Impact on corporate reporting (RQ 2)

- The impact of FBU on corporate reporting is viewed positively. The impact on 'front-half' content is perceived as relatively modest. Impact on the presentation of content and on the extent to which the annual report generally, and the 'front-half' specifically, presents a cohesive 'story' is viewed as significant. In many cases, the regulation is also perceived to have resulted in a more conscious and reflective process for considering whether annual reports are FBU.
- There is little suggestion of FBU impacting on the cutting of 'back-half' clutter, a finding reinforced by the continuing growth in the length of annual reports.
- The incremental costs of implementing FBU are viewed generally as insignificant.
- In general, there appears to be a positive relationship between company size and the complexity of the process put in place to implement FBU. Regardless of the formality of process, companies approach FBU carefully.

Feedback from investors (RQ 3)

- Research participants have received little feedback on FBU, whether positive or negative, from investors. It is unclear whether this reflects lack of interest, greater prioritisation of other contemporary initiatives or belief that the entire annual report is already audited.

FBU: Impact on audit and assurance (RQ 4 and RQ 5)

- Not all research participants believe that reporting on FBU, by exception, has resulted in significantly enhanced assurance on the 'front-half' as compared with the previous 'consistency' requirement. There is a substantial element of opinion, however, which does view FBU as having resulted in significantly

enhanced assurance; not least because it gives auditors serious 'ammunition' with which to challenge companies on how they are meeting their FBU obligations. The assurance provided is viewed by some individuals as enhanced by synergies resulting from contemporaneous regulatory initiatives on audit reporting and audit committee reporting.

- The FBU obligations placed on auditors do not generally present any particular challenges and the incremental costs are regarded as insignificant. There is some suggestion of auditors doing more work than previously on 'non-financial' 'front-half' numbers.
- There is general recognition that positive assurance on at least some 'front-half' content is technically feasible but no strongly held general opinion favouring such assurance overall. There is, however, significant comment by audit partners in favour of positive assurance. Some see this as entirely possible. The importance of an agreed framework for the provision of positive assurance is emphasised. There is some suggestion that the dividing line between reporting positively and by exception may be less stark than sometimes depicted. Reservations about positive assurance include the perceived difficulty of opining positively on some content, the inherently subjective nature of the 'front-half' and conflation of management and auditor roles. The research does not suggest any strong sense of demand from investors. In the case of positive assurance, anticipated costs are regarded as significant.

Auditor skills and expertise (RQ 6)

- There is little sense of auditors having had to become familiar with new skills in order to engage with FBU but some strong opinion that, in particular, more junior auditors' commercial awareness and understanding is inadequate. Auditors are viewed as inhibited by technical accounting requirements or by a contemporary audit environment which is compliance-driven. There may, therefore, be a need for future auditor training to incorporate a greater explicitly commercial element.

Policy implications

- At the most general level, FBU is regarded as a 'good thing' and benefits are perceived as outweighing costs. There is no sense of any perceived need for radical revision of the FBU regulation. Given the generally favourable reaction to FBU within the UK, there may be scope for the implementation of similar regulations within other national jurisdictions or by international regulators.

- There is a possible need for more detailed regulatory guidance on how terms such as 'balanced' or 'understandable' should be interpreted.
- Differing opinions as to whether or not the assurance provided under FBU has enhanced that required under the previous 'consistency' requirement might lead the FRC to reflect as to the extent to which the FBU regulations are intended to enhance the value of the assurance provided on the 'front-half'.
- There is no evidence of a strong desire for the FRC to upgrade the assurance requirement for FBU to a positive opinion. That eventuality, however, would require agreement on a clear framework for positive assurance as well as appraisal of the skills and expertise which would be necessary for such assurance.
- There is a need for further research on investors' assurance needs and on the reliance which they place on the annual report, as compared with alternative information sources, in order that policy makers are properly informed in the event of revising or upgrading the 'front-half' assurance requirement.
- The perception that auditors, particularly those more junior, may be insufficiently focused commercially have implications for professional bodies and regulators. This suggests a possible need to carefully review the nature and scope of auditor training.

Recommendations for further research

- There is scope for research which explicitly investigates stakeholders' interpretations of FBU as a concept.
- The relatively modest impact on corporate reporting identified here may reflect high quality reporting in larger FTSE companies. Further research might usefully investigate the impact on smaller listed companies, e.g. FTSE Smallcap.
- There is uncertainty as to how investors regard both the current assurance provided on the 'front-half' as well as its possible upgrading to a positive opinion. The nature of the positive assurance, if any, desired by investors requires exploration; e.g. whether this is general or is restricted to certain 'front-half' components only. It is also an open question as to how competent investors perceive auditors to be as the potential providers of such assurance.
- There is a need to explore the precise nature of the reliance which investors place on the annual report as compared with alternative information sources and

to elicit views as to whether or not such alternative information sources might benefit from external assurance.

- Perceptions that auditors lack commercial awareness or focus suggest a need for research into the nature of auditor training and career development.

1. INTRODUCTION

Developments in corporate and audit reporting, with the latter sometimes a response to the former, have continued over the past decade, both in the UK and internationally. One of the more significant developments is the decision by the UK Financial Reporting Council (FRC)[2] to require the boards of premium listed companies[3] to state in their annual reports, for financial years ending on 30 September 2013 and later, whether or not they consider that:

> *… the annual report and accounts, taken as a whole, is 'fair, balanced and understandable' and provides the information necessary for shareholders to assess the company's performance, business model and strategy.* (FRC 2014a, C.1.1)

This regulatory development may, arguably, represent a step change in the views of regulators, as well as the perceived views of users, as to the importance of the, largely, narrative content of annual reports, relative to the financial statements themselves. It certainly reflects a trend of increasing quantity, and arguably, enhanced quality, of the narrative information disclosed by major companies.

The FBU initiative, however, is concerned not only with corporate reporting but with audit and assurance. The obligation imposed on corporate boards to report in 'fair, balanced and understandable' (FBU) terms has led to a corresponding obligation on external auditors who are now required under *ISA 700* (FRC, 2013) to report by exception on boards' FBU assertions. Reporting by exception is required where the board's statement, confirming that the annual report is FBU, is '*inconsistent with knowledge acquired by the auditor in the course of performing the audit*' (FRC 2013, paragraph 22 B(a)). The wording implies an enhanced level of assurance on the 'front-half' compared with that stipulated by the Companies Act 2006 which merely requires auditors to confirm that the directors' report, and for financial years ending on or after 30 September 2013, the strategic report, are consistent with the financial statements. There is no clear evidence, however, as to whether investors, auditors or companies themselves view the new requirements as resulting in enhanced assurance. A further issue arises as to how feasible it would be for the auditors' duty to report by exception to be upgraded to providing a positive opinion[4].

While FBU is concerned with both corporate and audit reporting, the primary responsibility in terms of the necessary annual report content and quality, rests with corporate boards. This reflects the more general governance model preferred by the FRC, whereby disclosure of information regarding companies is the responsibility of boards rather than auditors with the latter only commenting on what is already disclosed by companies; disclosures on the audit approach and process constitute an exception to this rule. FBU is part of a more extensive and mandated portfolio of recent changes to corporate governance, corporate reporting and audit reporting. The narrative sections of the corporate annual report are a particular focus of these developments. New legislation requiring companies to produce a strategic report replaces the obligation to produce a business report. Thus FBU itself, the strategic report legislation, and other mandated changes, e.g. to directors' remuneration disclosures, all impact on corporate annual reports.

This report presents research on the impact of FBU, and of other related developments, on UK corporate reporting and on the work of preparers, audit committees and, especially, external auditors.

The research forms part of a more extensive ICAS agenda, which while concerned to enhance the usefulness of corporate reporting with a particular focus on narrative disclosures such as management commentary (see e.g. ICAS 2010a, ICAS 2012), also aims to identify the demand by investors for positive 'front-half' assurance. This research, therefore seeks to identify the level of assurance currently provided under FBU and the perceived desirability and feasibility of auditors opining positively on the annual report as a whole. The research is also set in the context of a longer running series of developments in corporate reporting, corporate governance and auditing, involving radical amendment to the associated UK regulatory framework. More specifically, the research has evolved from prior research commissioned by ICAS and from subsequent discussion papers and position statements. The following section summarises key elements of this journey while the research background and other recent developments are explained more fully in the following chapter.

Previous ICAS research and developments

The financial and economic crisis of 2008-2009 led among other developments to the issue of a practice statement by the International Accounting Standards Board (IASB, 2010) on management commentary. The increasing importance of narrative disclosures and, in particular, the issue of the IASB practice statement (IASB, 2010), together with concerns about the opaqueness and usefulness

of corporate reporting, provided the springboard for ICAS discussion papers (2010a, 2012) arguing for shorter and more transparent corporate reporting. At the same time, the absorption of management commentary into the standard reporting package for major companies suggested a need to identify whether there was user demand for 'front-half' assurance and whether auditors could and would respond appropriately. ICAS funded a two stage research project into this issue. The research also explored other issues, including views as to the value of contemporary audit reports and the robustness of the audit process. The first stage was concerned with identifying user views and the second those of auditors; for details of the research see Fraser *et al.* (2010), or Fraser and Henry (2010), and Fraser and Pierpoint (2011) or Fraser (2011).

One of the key results of the research was evidence of demand from both users and auditors for 'front-half' assurance. This research, together with contemporaneous public concern about the state of the external audit function, led to ICAS publishing several discussion papers or position statements; *The Future of Assurance (FoA)* (ICAS, 2010b); *Balanced and Reasonable (BaR)* (ICAS, 2013) and *Assurance on Management Commentary - Where Next?* (ICAS, 2014).

FoA proposed that external audit and assurance reports would include an opinion as to whether annual reports, other than the financial statements, were 'balanced and reasonable' and *BaR* developed this proposal further. FBU was implemented by the FRC shortly after the publication of *BaR*. Responses to the *BaR* proposals signalled uncertainty about how FBU was working in practice; this research, therefore, seeks to identify the impact which FBU has had on both corporate and audit reporting.

Report structure

Chapter 2 describes the detailed background to the research. Much of the academic literature is covered in Fraser *et al.* (2010) and in Fraser and Pierpoint (2011); Chapter 2, therefore, concentrates on recent professional developments concerned with both corporate reporting and audit and assurance. Chapter 3 explains the research method including the selection of the case companies and the design, execution and analysis of the interviews. Interviewee profiles are described. Chapters 4 to 8 present the research results. These chapters discuss the views of the three key constituencies (auditors, preparers and audit committee representatives), who participated in the research. Chapter 4 reflects on the different interpretations placed on FBU by interviewees. Chapter 5 deals with the perceived impact of FBU, and of other related regulation, on corporate reporting.

Chapter 6 discusses the assurance presently provided by auditors under FBU. Chapter 7 explores views on upgrading this assurance to a positive opinion on the 'front-half'. Chapter 8 considers contemporary auditor skills in the light of FBU. The final chapter summarises the results, draws conclusions and makes policy recommendations.

2. SETTING THE SCENE: BACKGROUND AND RECENT DEVELOPMENTS

The previous chapter discussed the ICAS research and policy proposals which have facilitated the present research. This chapter provides greater detail on the academic, professional and regulatory background. Developments in both corporate reporting and audit and assurance are addressed.

Narrative corporate reports

Previous UK and US literature suggests that corporate reporting is likely to assume an increasingly narrative character (see Fraser *et al.* 2010, chapter 2). While earlier research (e.g. Epstein and Pava, 1993; Bartlett and Chandler, 1997; Rogers and Grant, 1997) communicated mixed messages, recognition that financial statements have become over-complex, even for expert users, means that the 'front-half' is increasingly seen as key to reporting quality. Fraser *et al.* (2010) found that both investors and non-investor users find management commentary, as a specific component of the annual report, to be useful. Fraser and Pierpoint (2011) found these views mirrored in auditor opinion with some suggestion that the perceived increase in the importance of management commentary was positively related to financial statement complexity.

The increasing significance of narrative reporting, especially management commentary, is reflected in both national regulatory developments and, particularly, the IASB's Practice Statement *Management Commentary* (IASB, 2010). This non-binding practice statement is not an IFRS, and compliance is voluntary. Nevertheless, management commentary is now clearly viewed internationally as part of the listed company reporting package. Achieving high quality management commentary presents challenges. 'Impression management' is recognised as a 'front-half' phenomenon (Stanton & Stanton, 2002) and management commentary has developed as a sophisticated marketing tool (Mckinstry, 1996).

Davison (2011, 2015) discusses the power of the visual in accounting communication using the UK annual reports of one of the Big 4 accounting firms. Davison's work suggests how, in the context of corporate reporting, the perceived quality and creativity implicit in visual works may come to be attached to the reporting entity itself. Davison suggests that:

> *… visual media and visual rhetoric, e.g. in annual reports, on web pages or in directors' presentations, are frequently more powerful and revealing than the numbers and narratives composing the technical content to which the bulk of accounting research has been directed.* (2015, p.31)

Thus visual annual report content has potential FBU implications.

Schleicher and Walker (2010) argue that bias in forward-looking narratives suggests the need for regulation and some sort of formal external review or audit process. Implementing some form of audit process on the 'front-half' presupposes that the service provided by auditors would be of the necessary quality and that the opinion provided would be appropriate and sufficiently transparent. While audit quality is a long-standing issue and was the subject of criticism in the aftermath of the 2008-2009 financial crisis (see e.g. HCTC, 2009), the imperative behind the FRC's FBU initiative appears to be, firstly, to enhance the quality of corporate disclosure and then, secondly, to reinforce this by a quality audit and assurance function (see FRC, 2011a).

Nevertheless, the perceived importance of management commentary and narratives to users and the challenges involved in ensuring high quality reporting raise the question of whether external assurance should be provided on the complete annual report rather than merely on the financial statements. Recent ICAS developments which have been the immediate springboard for the present research have an assurance emphasis as opposed to what is arguably the corporate reporting focus of the FRC initiative. Assurance issues are explored in the following two sections.

'Front-half' assurance

Possibilities for enhancing audit reports go well beyond the provision of an opinion on the 'front-half' which is the focus of the present research. Vanstraelen *et al.* (2011) distinguish five ways of enhancing audit reporting - clarification of the scope of the financial statement audit and language in the audit report, information on the audit team and engagement statistics, information on the audit process, information on the results of the auditor's evaluation of the financial statements and disclosures beyond the scope of the financial statement audit – and give a useful summary of research in each of these areas. The focus of the present research on the 'front-half' comes within the scope of the last of these five areas. This focus is therefore limited but one clearly signalled by regulators (see FRC, 20011a) as being of high priority. There is also an argument that much of the value associated with the

audit is derived simply from the knowledge that an audit has taken place, and the subsequent seal of approval which this provides, rather than from the content of the audit report *per se* (Epstein, 1976). There is also, however, convincing evidence of the specific information content of audit reports (see Vanstraelen *et al.* 2011).

In one sense, calls to extend assurance to the 'front-half' are ironic since, in the wake of the financial crisis, there were suggestions that for certain entities, the financial statements themselves, with greater connotations of rigour and verifiability, were almost 'too difficult' to audit. While 'softer' assurance than that implied by audit and the 'true and fair view' requirement is generally viewed as inappropriate for the financial statements, it may be more appropriate for the 'front-half'. There are concerns as to how feasible 'front-half' assurance is in 'true and fair' terms. Fraser and Pierpoint (2011) and Fraser *et al.* (2010) suggested that assurance on management commentary is regarded as important by auditors and users. The enthusiasm of professional investors for assurance on management commentary was identified as less than of users generally; this reflects factors such as desire not to inhibit the freedom of corporates to 'tell a story', privileged access to other information such as analyst briefings and, possibly, reservations about auditors' capability to engage meaningfully with the 'front-half'. Some users have expressed a desire for assurance on the strategic report (ICAEW, 2013).

Fraser and Pierpoint (2011) highlighted that assurance on management commentary is regarded by auditors as feasible technically but that enthusiasm is constrained by non-technical considerations. These include: uncertainty regarding the precise wording of the opinion which could be given; concerns about blurring of management and auditor responsibilities; and auditor liability implications.

If 'front-half' assurance is regarded as desirable in principle, a further question arises as to the appropriate extent of the assurance. Fraser *et al.* (2010) found users more favourably disposed to rigorous assurance approaches for historic or quantitative elements of management commentary. For elements of management commentary such as future prospects or forecasts, however, 'lighter-touch' forms of assurance and reporting were favoured. Auditor views identified (Fraser and Pierpoint, 2011), as to the feasibility and desirability of different forms of assurance, were largely consistent with those of users; a substantial majority appeared to believe that some assurance was possible over even the most challenging management commentary content.

Professional developments

Balanced and reasonable

After the 2008-09 financial crisis, parliamentary concern was expressed about auditing in the banking sector, being highlighted, for example, by the ninth report of the House of Commons Treasury Select Committee (TSC) for session 2008-2009 (HCTC, 2009, para.221) which suggested that:

> *... the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is.*

This provided further impetus for *FoA* (ICAS, 2010b); its proposal that the external audit and assurance report would include an opinion as to whether the annual report, other than the financial statements, is 'balanced and reasonable' (ICAS, 2010b, p.26) received the approval of the House of Lords Economic Affairs Committee (HLEAC) in its 2011 enquiry 'Auditors: Market Concentration and their role' (HLEAC, 2011)

The term 'balanced' was intended to emphasise that views expressed by boards should reflect a realistic perspective of the business and not be subject to 'spin' or 'bias'. A 'balanced' report, most obviously, would not be one where information was chosen in order principally to highlight the positive. 'Reasonable' was chosen with the intent of ensuring that the views expressed were appropriate, based on information available at the time, directly or indirectly through the audit of the financial statements or other information available in the public domain, and that similarly skilled professionals would have reached the same conclusion. The implications for the assurance provider of a 'balanced and reasonable' opinion on the 'front-half' were considered by *BaR* (ICAS, 2013). Drawing on current International Standards of Auditing (ISAs), *BaR* suggested some of the processes which auditors might follow when opining on the 'front-half'.

Balance and reasonable: Interpretation

BaR also expanded on the understanding of 'reasonable' given in *FoA*, suggesting that a 'reasonable' report implies that the underlying assumptions and the judgements made by the directors are sensible and justifiable in the circumstances. *BaR* suggested that this interpretation implied that auditors would ensure that, given the current and expected future performance of the company, the information

disclosed was consistent with the view given by the financial statements (ICAS, 2013, p.6).

The term 'reasonable' as opposed to 'fair' was chosen to ensure a clear distinction between the proposed opinion on the 'front-half' and the 'true and fair' opinion on the financial statements. *BaR's* interpretation of 'reasonable' and the choice of the term as an alternative to 'fair' suggests that *FoA* and *BaR* envisage little difference between the two terms.

BaR argued that the 'balanced and reasonable' opinion be expressed in positive terms rather than 'negatively' or by exception which it was suggested, was 'opaque, not well understood by the user and is confusing as to the degree of assurance which is provided' (ICAS, 2013, p.7). *BaR* acknowledged that the scope of a positive opinion might require limitation; in particular, with respect to forward-looking information. Thus, *BaR* highlighted the centrality of judgement to the audit work necessary to arrive at a 'balanced and reasonable' opinion and proposed caveats to deal with the inherent uncertainty of some information.

Similar issues arise with the FRC's FBU requirement; while the FRC has indicated that FBU is a matter for board judgement, no official guidance exists on how each of its constituent terms should be interpreted. Stephen Hadrill, FRC Director General, has suggested that 'fair, balanced and understandable' should be interpreted in accordance with standard dictionary meanings. Evidence (Adelberg and Farrelly, 1989; Houghton and Hronsky, 1993) suggests, however, that interpretation of many accounting concepts differs between different subjects. Evans *et al.* (2015) suggest this is the case even when subjects speak the same language. A further question arises as to whether FBU should be interpreted holistically or as a combination of three discrete elements. This issue is not new; the question of whether the not dissimilar 'true and fair view' requirement reflects one cohesive concept or two separate elements is considered by Rutherford (1989), Nobes and Parker (1991) and Parker and Nobes (1991).

International regulatory developments

International developments include more absolute positions regarding assurance on narratives. The South African Institute of Chartered Accountants suggests that:

> *Assurance cannot generally be expressed on prospective and future information; however organisations can obtain assurance on the processes and assumptions leading to forward-looking*

statements. (SAICA, 2011, p17)

The current German position (IDW, 1998) is that, in accordance with paragraph 322 ABS 3 SATZ 1 HGB of the German commercial code, auditors are required to provide 'reasonable assurance' over the 'combined' - group and holding company - management report, confirming that this 'as a whole provides a suitable view of the group's position and suitably presents the opportunities and risks of future development'. German 'front-half' audit reports do not normally appear to be limited in respect of particular content, e.g. future-orientated information. The German and South African positions, therefore, represent two very different perspectives on this issue.

The audit opinion given under the German standard is on the management report as a whole; thus while areas such as directors' opinions, forecasts, projections, risk assessment and 'non-financial' KPIs are not excluded from the standard's scope, specific opinion on such matters is not offered. Anecdotally, there appears to have been little user reaction to the German standard, although there is some suggestion that users assume that the whole annual report is audited.

The German standard is currently under revision; this may deal with so-called unassurable assertions. Three possible ways of doing so are: including an onus on the client to remove such material; a similar obligation to reform such assertions so that they are more evidence-based and can be assured; and for the auditor to disclaim an opinion on these assertions. The suggestion in *BaR* that opinions might include caveats to deal with the inherent uncertainty of some narrative content offers a further option.

In the US, the American Institute of Certified Public Accountants (AICPA) adopts an intermediate position with AT Section 701 of *Statement of Standards for Attestation Engagements (SSAE) 10 on Management's Discussion and Analysis (MD & A)* (AICPA, 2001) recommending the inclusion of a paragraph on the unpredictability of future events and their expected impact.

Assurance on management commentary - Where next?

The responses to *BaR* (ICAS, 2013) were summarised in the follow-up publication *Assurance on management commentary - Where Next?* (ICAS, 2014). Responses indicated support for the proposals with many auditors viewing extension of 'front-half' assurance as inevitable. It was, however, suggested not only that demand for the envisaged assurance was uncertain but that users may be confused as to the

assurance currently provided on the 'front-half'; this is unsurprising as there is user confusion over assurance provided by auditors generally (Gray *et al.* 2011). There was concern expressed as to how auditors could express an unqualified opinion over 'front-half' assertions unsupported by appropriate evidence. The likely costs of extended assurance over the 'front-half' appeared, perhaps surprisingly, to be a matter of concern principally to auditors. Other responses to *BaR* highlighted perceived obstacles including: the inhibiting of board opinion in management commentary; the existing auditor liability regime; and perceptions that some 'front-half' content is inherently unsuitable for assurance.

There are other corporate reporting issues. The FRC's *Clear and Concise Initiative* (FRC, 2015) deals with the quality of communication in corporate reporting and specifically prioritises 'cutting clutter'. *Clear and Concise* builds on guidance such as the FRC's *Guidance on the Strategic Repor*t (FRC, 2014c) which stresses the importance of innovation and materiality and addresses how best information may be positioned within annual reports. It is unclear whether FBU has resulted in any significant de-cluttering. An EY study of 80 annual reports from the FTSE 350 suggests otherwise, finding that 2013 reports are, on average, 10% longer than those for 2012 (EY, 2014).

Summary

This chapter reviews recent developments relevant to the research.

- There is growing momentum, academic, professional and regulatory, in favour of a high quality 'front-half' and some form of related assurance.
- Aspects of narrative corporate reporting highlighted by regulators and others include a desire to 'cut clutter', and acknowledgement of the potential impact of visual content and 'impression management'.
- There are a variety of international regulatory perspectives on 'front-half' assurance ranging from the confident to the very cautious.
- Terms such as 'fair', 'balanced', 'understandable' and 'reasonable' give rise to issues of interpretation.
- The ICAS 'balanced and reasonable' initiative evoked a variety of responses including concerns about costs and content over which positive assurance might be impossible.
- There is a desire to see how the FRC's FBU initiative is working in practice and this forms the springboard for the present research.

3. RESEARCH APPROACH AND METHOD

Research objectives and questions

The research objectives were to:

- Identify the impact of the FRC's 'fair, balanced and understandable' requirement and related regulation, especially the strategic report legislation, on corporate reporting.
- Identify the impact of the FRC's 'fair, balanced and understandable' requirement and related regulation on the work of the external auditor.
- Identify the extent to which it is regarded as feasible and desirable to upgrade the assurance provided on the 'front-half' from an exceptional to a positive opinion.

These objectives were achieved by eliciting the views of three key constituencies - auditors, preparers and audit committees - on the following research questions (RQ):

RQ 1 Is FBU considered to be an integrated concept or one of three discrete elements? How do individuals interpret the three elements within FBU?

RQ 2 What is the impact of FBU and other related regulation on corporate reporting, particularly the 'front-half'?

RQ 3 What opinions have been received on FBU and 'front-half' assurance from investors?

RQ 4 What is the perceived scope of the assurance which auditors now provide on the 'front-half'?

RQ 5 How desirable and feasible would it be to upgrade the assurance provided on the 'front-half' to enable the provision of a positive opinion?

RQ 6 How adequate are auditor skills in the context of FBU and other possible changes to assurance?

RQ 1 and RQ 2 include eliciting views on whether annual reports exhibit changes in substance as a result of FBU, or whether companies have merely put a process for considering FBU in place. Opinion was also elicited on issues such as the impact on the 'back-half' in respect of 'cutting clutter' and on whether the strategic report

legislation, specifically, has impacted on the 'front-half'. Views were elicited on the benefits of the regulatory changes. Opinion was elicited as to how FBU might be affected by such graphical, pictorial or similar content. Views were sought on areas which have proved troublesome for preparers, audit committees and auditors and on the costs of FBU.

RQ 4 includes identifying any ways by which auditors approach the audit differently following FBU and the nature, extent and cost of any additional assurance work.

RQ 5 includes identifying specific content on which auditors would find it impossible or difficult to issue a positive opinion.

RQ 6 includes eliciting opinion on the need for auditor training to reflect recent assurance developments.

These research questions were investigated by means of semi-structured interviews conducted with key individuals representing the three constituencies noted above. Interviewees, with one exception, were officers, senior employees or auditors of one of nine case companies.

Case companies

The nine companies selected for this project are all listed on either the FTSE 100 (7 companies) or FTSE 250 (2 companies).

As the research focuses particularly on audit and assurance, auditors of the case companies reflect an appropriate split across the major UK audit firms. Table 3.1 indicates the concentration of UK listed company audits for reporting years ended in 2013 (the most recent figures available at the time of selection of the case companies).

Given the distribution of audit clients as shown in Table 3.1 and that FBU is applicable only to companies with a premium listing, a prerequisite for inclusion in the FTSE UK series indices, the case companies were drawn from those of the six largest audit firms. Given the distribution of FTSE 100 and 250 audit clients over these six firms, the case companies included eight audit clients, two for each firm, selected from those of the Big 4, (PwC, KPMG, Deloitte and EY) and one client representing both BDO and Grant Thornton.

Table 3.1 - Concentration of UK listed company audits by audit firm for reporting years ending in 2013

Audit firm	Year end	FTSE 100 clients	FTSE 250 clients	Other audit clients listed on regulated markets
PwC	30 June	41	61	92
KPMG	30 September	23	54	130
Deloitte	31 May	21	70	80
EY	30 June	14	50	92
BDO	30 June	1	10	55
Grant Thornton UK	30 June	0	5	63
All other firms combined	variable	0	0	51

In order for the research to proceed, it was necessary to first obtain agreement both from these six audit firms and the case companies themselves. The consent of all six audit firms was first obtained as a result of a direct approach through ICAS. Each firm then proposed two audit clients, in the case of each Big 4 firm, or one audit client, in the case of BDO and Grant Thornton. The consent of each audit client was then obtained, usually by an approach through ICAS directly to the finance director or CFO. Unfortunately, no client from Grant Thornton was able to participate in the research. This gave a sample of nine companies with three interviews for each company, auditor, preparer and audit committee representative, giving a total of 27 interviews. Grant Thornton participated in the research through an interview with a technical partner; as a result the total number of interviews was 28.

The split of the nine case companies by sector and industry, according to the Global Industry Classification Standard, is shown in Table 3.2.

Table 3.2 - Company split by sector and industry

Sector	Number of companies	Industry	Number of companies
Energy	3	Energy equipment and services	1
		Oil, gas and consumable fuels	2
Financials	3	Capital markets	1
		Diversified financial services	1
		Insurance	1
Industrials	1	Commercial and professional services	1
Materials	1	Construction materials	1
Utilities	1	Water utilities	1
Total	**9**		**9**

Interviews

As noted above, three interviews were carried out for each case company, with, respectively, the signing audit partner, a director or senior employee with annual report preparation responsibilities and the chair of the audit committee or company secretary. The 'preparer' was always a senior member of the finance function - finance director or financial controller. Ideally, the audit committee representative was the committee chair; in several cases, the company secretary substituted.

Interviews were semi-structured around agendas containing between 17 and 20 questions. While specific agendas were prepared for each constituency, all were similar. The interview agendas delineated the principal areas for discussion with other issues being allowed to emerge. The annual reports and audit of the case companies formed the basis of discussion for each set of three interviews although the extent to which interviewees were prepared or able to discuss company-specific detail varied.

Each interview lasted between 40 and 70 minutes. All interviews were recorded and transcribed and then analysed using the NVIVO software package. The themes identified as the basis for coding and analysing the interviews were based upon the interview agendas and are shown in Table 3.3.

Table 3.3 - Themes used for analysis of interviews

Theme	Sub themes
Personal background	
FBU as concept	Meaning of fair, balanced, and understandable
	FBU one cohesive concept or three discrete elements
Impact on annual report	Impact on 'front-half' content
	Impact distinguishable from that of other regulation (e.g. the strategic report)
	Examples of changes from 2012(2013) to 2013(2014)
	Process for implementing FBU
	Role of audit committee
	Impact on 'back-half', e.g. cutting clutter
	FBU and graphical, pictorial or photographic content
	Costs to company of implementing FBU
	Overall 'a good thing'?
Feedback from investors	General
	On assurance
Present assurance on 'front-half'	Level of assurance provided by auditors
	Comparison with previous 'consistency' requirement
	Things done differently by auditors
	Things difficult for auditors
	Assurance costs of FBU
Positive opinion on 'front-half?	Desirability and feasibility of positive opinion
	Content on which positive opinion could be given
	Content on which positive opinion difficult or impossible
	Costs of providing positive opinion

Table 3.3 - Themes used for analysis of interviews (cont'd)

Theme	Sub themes
Auditor skills and future of assurance	New skills necessary as a result of FBU
	Auditor skills and training; general observations
	Future of audit and assurance

Chapters 4 to 8 include appropriate interview extracts. Table 3.4 shows the codes appended to the interview extracts to identify the 28 interviewees.

Table 3.4 - Codes used to identify interviewees

Codes	Interviewee category
AC1-AC9	Audit committee chair or company secretary
AP1-AP10	Audit partner
FD1-FD9	Finance director or financial controller

Summary

- The research has three objectives which were achieved by identifying the views of three key constituencies - auditors, preparers and audit committee representatives - on six research questions.
- Semi-structured interviews were carried out with key individuals representing these three constituencies. Twenty eight interviews in total were carried out; with one exception, interviewees were officers, senior employees or auditors of one of nine case companies.
- The nine case companies were all clients of the Big 4 Audit firms (eight) or of another major accounting firm (one).

4. FAIR, BALANCED AND UNDERSTANDABLE: INTERPRETATION

The main principle of the UK Corporate Governance Code (FRC, 2014a), in respect of financial and business reporting, is that 'the board should present a fair, balanced and understandable assessment of the company's position and prospects' (FRC, 2014a, Section C.1). The requirement for boards, as well as auditors, by exception, to confirm that the annual report is 'fair, balanced and understandable' appears simple but potential complications exist. The Code does not define 'fair', 'balanced' and 'understandable'. Similarly, of course, the definitions of 'true' and 'fair', applicable to financial reporting, are not defined in statute. The most authoritative statements on the meaning of 'true and fair' are legal opinions[5]. The FRC has recently published guidance (FRC, 2014b) on how 'true and fair' may be applied in financial reporting but does not consider 'fair', or indeed 'true', as discrete terms. There is no corresponding exploration of the meanings of 'balanced' and 'understandable'.

The first research question explored these interpretation issues.

Integrated concept or three discrete elements?

Most interviewees indicated that they viewed FBU as an integrated concept albeit one of three, perhaps inter-related, elements.

An experienced audit partner offered possibly the most general explanation:

> *Other than the common use of the words in combination … a lot of this is around experience and judgement … does this tell a story, which is recognisable to me as someone who does know a bit more, perhaps, of the business? For me that's the acid test about what is 'fair, balanced and understandable' … there is always an element of positive description and that's fine provided there is an overall balance and it's not distortive and not too detailed either.* (AC2)

This is essentially a common sense, rather than a technical, interpretation, which emphasises the importance of 'balance' at the same time accepting a degree of 'positive description'. Other holistic perspectives on FBU reflect difficulties in

distinguishing 'fair' and 'balanced':

> *I am not really sure what the difference between 'fair' and 'balanced' is … even if you looked in Roget's Thesaurus I'm sure you'd see 'fair' and 'balanced' are probably similar to one another.* (FD6)

> *… if something's 'fair' then it's going to be 'balanced' … 'fair' and 'balanced' I do see as the same thing.* (FD7)

An audit partner suggested that while FBU has three elements, these are not discrete and that FBU implied realising all three elements:

> *I would view it very much as one package and very much that it is probably difficult to be 'fair' if you are not 'balanced'. It is probably difficult to be 'fair' if you are not 'understandable'. So I think the three elements are all intrinsically linked in terms of delivering what you are trying to do. I think there is a theory or concept behind 'fair, balanced and understandable' which you can only deliver by achieving all three.* (AP1)

This partner also signals that he visualised FBU as a general 'signifier' of a generic improvement in reporting rather than as something in itself.

> *I view it very much as a part of the overall evolution of financial statements - not as either three discrete elements or even in itself a* [distinct] *thing that has to be achieved.* (AP1)

Some individuals, however, view FBU as composed of three distinct and separate elements. One preparer indicated how she believed that the 2013 regulations made an impact:

> *I would say that there is probably a distinction between 'fair, balanced and understandable' in these three captions. It has made people think specifically in those buckets; previously I think we would have had an overall view that you want to be 'fair, balanced and understandable'. Now there are three discrete elements to that thinking so that was maybe a subtle change.* (FD5)

This provides a different perspective on FBU although there is no evidence suggesting a different end result because of this.

Fair and balanced?

Thus some individuals believe that it is difficult to achieve a particular FBU element without meeting one or both of the other elements but this is not a universal opinion.

> *I think the juxtaposition of the two words is actually pretty straightforward. Is it fair? My interpretation of that is whether or not a reasonable person would think it was 'fair' if they read it. Is it 'balanced'? It might be a fair reflection of what you've done but is it 'balanced' in terms of the reader understanding the impact of what you've achieved? So if you're reporting on last year's performance, for example, it might fairly represent what that performance was, but have you fairly represented the balance of what went well and what didn't?* (FD8)

The audit partner for a FTSE 250 company viewed FBU holistically while acknowledging each element as distinctive; all elements were not equally challenging.

> *... when I'm reviewing a set of financial statements I probably do think of* [FBU] *as a package and probably in terms of 'Is this clear and transparent and consistent with my understanding of the business?' However, they are three things and there are probably more difficulties with achieving one or two of them than the others. I think 'understandable' is interesting. If it's 'understandable' you can read and understand it, but if you take the 'front-end' and 'back-end' together do you understand everything you need to? 'Balanced' depends on the client ... some of them still see this as an opportunity to say all the good things about their business. I think, increasingly, people are being more balanced, certainly my clients seem to be, but I think that is probably the one that is the hardest in terms of getting the client to be in the right place. 'Understandable' is harder because of the conflicting statutory requirements. 'Fair', I don't generally have any issues with to be honest but that is a bit more of a woolly word.* (AP7)

This partner therefore envisages 'fair' and 'balanced' as different with 'balanced' presenting greater challenges. An audit committee chair suggested that 'balance is [a] helpful elaboration of fairness'. (AC9) Two experienced audit partners offered essentially similar distinctions between 'fair' and 'balanced':

> *'Balance' is equal weight and column inches given to the good and the bad … 'fair' is being honest in the way you then describe the good and the bad.* (AP8)

> *'Balance' is more I would say about content and completeness and 'fair' is about emphasis and depth and colour.* (AP9)

AP7 and AP8 are both from one Big 4 firm; thus partner views appear personal rather than corporate. Another senior partner was dismissive of the corporate view.

> *I can only presume that there is some in-house guidance but it doesn't trouble me. But I presume there is some and I must actually get hold of it and have a look at it just out of interest.* (AP4)

Thus, interviewees may view 'fair' and 'balanced' differently. A FTSE 100 finance director viewed 'balanced' rather differently; being concerned with 'the 'back-end' of the accounts tying in with what we say in the 'front-end'' (FD9). An absence of clear definitions may encourage individual interpretations but in no case led to individuals experiencing difficulties in forming personal views as to whether annual reports are FBU.

Understandable to whom?

Understandable was the FBU element which was most obviously considered by interviewees and that which most individuals viewed as enhancing existing regulation. Some individuals believed that making annual reports 'understandable' could be achieved only for 'expert' users. The partner for a large oil and gas operator stated:

> *Who actually does understand the accounts?* [I have always been concerned] *as to what 'understandable' means … 'understandable' to whom? Only to the highly expert user, in my view, is the 'back-*

end' 'understandable'. So we are effectively only saying it is 'fair, balanced and understandable' given that constraint. (AP4)

The challenge of making the 'back-half' 'understandable' was one echoed by others with views sometimes being industry-specific. Thus, the audit partner for a large insurer suggested:

If you look at the insurance industry you're dealing with a reporting basis that is at best opaque. We don't have a proper IFRS standard and so one of the things that the word 'understandable', I think, made a lot of clients think about was actually whether if you add up all of this stuff you come up with something that is remotely clear to the reader. (AP3)

The insurer's financial controller was more hopeful:

The question is: is it 'understandable' now? We try and achieve that and of course there is a degree of assumed knowledge. What you don't do … is go back to first principles and say 'how does an insurance contract work?' When we came to do the strategic report it was a great way of using material to articulate how the business worked … there was a desire for us as an organisation to make the business more accessible and more understandable … and so starting with a new chairman and new chief executive we said we want to have a simpler set of KPIs … when you're thinking about the 'understandable' bit you say 'this is how we're talking to investors, this now is how we should talk to the broader public' … when we're doing the strategic report we were not designing that for the professional investor. We were designing that for the ordinary shareholder. We have an analyst pack which we produce at the same time that's for the professional investor. (FD3)

This highlights three points. First, the insurer has interpreted 'understandable' as aimed at the 'ordinary shareholder', but not by driving to the 'lowest common denominator'. Second, the 'front-half' is designed for the ordinary rather than the professional shareholder, reflecting both 'back-half' complexity and alternative information sources for professional users. Third, corporate initiatives to make annual reports 'understandable', or 'balanced and understandable', may reflect FBU less than they do entity-specific developments.

Comparing the audit partner and financial controller perspectives, it is notable that the partner chooses to focus on technical accounting requirements for the industry and the consequent opaqueness of the 'back-half' while the latter highlights opportunities to make the 'front-half' more accessible. This is illustrative of the many nuanced nature of 'understandable'. Not only is there the question of 'to whom' but, despite the FBU requirement referring to the whole annual report, there is potential for focussing on one particular area when applying FBU. A perceived over-emphasis on technical accounting, as opposed to commercial issues, is a criticism of auditors articulated by all categories of interviewee although perhaps most obviously by preparers. A different approach to making the annual report 'understandable' is that of a diversified financial group in the FTSE 250 with a large number of small shareholders including ex-employees:

> *We always want to be … very, very 'understandable' because as I say, it goes to a much wider audience than just your suits in the city. We have a lot of individual shareholders that used to be employees. I'd say the vast majority of people will be able to take our Annual Report - and don't get me wrong. …. we sometimes get a bit repetitive … and go away with a really good understanding of what we do.* (FD7)

Like some other cases, the imperative here for group reporting to be FBU is not primarily regulation-related but reflects a long-standing 'mission', almost evangelical in character, to make the group's reporting, for which it had won several different awards, as transparent and understandable as possible.

Different approaches to making the annual report understandable, as illustrated in this section, suggest that 'understandable' is the element which allows most scope for differences in interpretation which conceivably could make a tangible difference to the content or presentation of the annual report. Companies do appear to approach the 'understandable' issue in a way which reflects the needs of the particular industry; nevertheless the potential for idiosyncratic interpretation arguably suggests scope for more regulatory guidance on this issue.

Balanced and reasonable?

Previous ICAS research (ICAS, 2010b; 2013) suggested that auditors should opine positively as to whether the 'front-half' of the annual report was 'balanced and reasonable'. Opinion was therefore elicited as to the desirability of reporting framed around confirmation that the report was 'balanced and reasonable' (BR) rather

than FBU. Only one individual, a FTSE 100 finance director, commented relatively favourably on BR indicating that it constituted a more ambitious barrier:

> *I think that 'reasonable' is a harder test than 'understandable'. I think you can understand something without it necessarily being 'reasonable' …. I understand why the FRC may have decided not to [adopt BR] because their job is to get to a place where everybody can pretty much stand behind what they're trying to do.* (FD8)

A few interviewees, two being the audit partner for, and the deputy finance director of, one case company, professed - perhaps surprisingly given the respective dictionary definitions for 'reasonable' and 'understandable' - to see no substantive difference between FBU and BR. They may, however, have been comparing 'fair' with 'reasonable' and an audit committee chair unconsciously linked both concepts; he understood "'fair' [to be] a reasonable explanation of the facts'. Other individuals viewed FBU as superior; reasons were either that 'reasonable' was largely indistinguishable from 'fair' and therefore had no incremental value or that 'reasonable' was much harder to define than 'understandable'. There appears, then, to be little support for a 'balanced and reasonable' 'front-half' opinion.

Summary

Several conclusions emerge in terms of how individuals interpret FBU.

- There is a variety of perspectives, ranging from viewing FBU as one concept or even as code for a generic enhancement of corporate reporting to viewing it as three distinct, almost disparate elements.
- 'Fair' and 'balanced' are viewed as interchangeable by some but as distinct by most. Despite the absence of authoritative guidance, individuals consider 'understandable' carefully with various resultant interpretations.
- An absence of mandatory definitions for 'fair, balanced and understandable' does not appear to inhibit individuals' perceived ability to comprehend what the regulation requires. Nevertheless, there may be scope for enhanced guidance on interpreting FBU most obviously because of scope for different views on making annual reports 'understandable'.
- There is no consistency of view in interpretations offered either by the individuals 'representing' each case company or by audit partners from the same firm. The former observation is unsurprising, the second perhaps less so; discussions

between preparers, audit committees and auditors centre on reporting rather than definitional matters.

- There is little support for 'balanced and reasonable', as previously proposed by ICAS, as superior to FBU.

5. FAIR, BALANCED AND UNDERSTANDABLE: IMPACT ON CORPORATE REPORTING

The second research question concerns the impact of FBU, and of related regulation, especially that concerning the strategic report, on corporate reporting. This chapter therefore explores the impact of FBU on corporate reporting, particularly on the 'front-half'.

A comparison of pre-FBU (2012 or 2013, depending upon the company year-end) and post-FBU (2013 or 2014) annual reports for each case company was undertaken, pre-interview, with a view to identifying substantive changes which had occurred over these two years. While there was some evidence of change, such as more explicit or clearer articulation of the business model, the major impression is of increased length; approximately 20 pages, or 10 per cent, on average, due substantially to revised Directors' Remuneration Report regulations. There is no general indication that FBU has led to shorter reports. The post-FBU annual reports of the case companies generally do not appear to be markedly superior to reports pre-FBU although there are individual instances of change such as a much clearer strategic report or the use of visual images in order to make the company's explanation of its business model more accessible. Often perceptions of improvement are essentially subjective. Nevertheless, interviewees gave examples of more generic impact on corporate reporting as discussed in the following sections.

Impact of FBU on 'front-half'

FBU is perceived generally to have had a significant, but not dramatic, impact on the 'front-half'. FBU, however, does not appear to have changed substantive 'front-half' content significantly. A 100 FTSE finance director suggested that the impact was:

> *In terms of what we produced in outcome probably not very much. What it did, however, change was the internal processes by which we got there … we've always tried to do something which ultimately turned out to be 'fair, balanced and understandable' … now I think at the margin we probably got a better balance. That's probably the main improvement. I don't think we ever produced anything which was unfair. We did improve understandability*

in a way. So I think the 'balanced and understandable' elements improved marginally but what did happen was a more formal process. (FD8)

This view is typical; there is no major content change, but the obligation on boards to confirm that their corporate reports are FBU has resulted perhaps in the adoption of a more formal process, but certainly more conscious deliberation as to whether annual reports are FBU, accompanied perhaps by enhancement of one or more FBU elements. The finance director's views also reflect those of the audit partner:

The impact has not been dramatic. XXXX as with many companies, I think, has been on a journey in terms of its reporting. What I think 'fair, balanced and understandable' has done is cause them to relook at the structure of what they do. 'In communicating to not just our shareholders but to the wider customer community, how can we actually make this more understandable?' And I think that has worked for them and for a lot of other big companies. In terms of 'fair and balanced' XXXX is not a client that I have had a concern about previously to be honest. (AP8)

One reason for the modest impact on content is that all the case companies clearly regarded their reporting responsibilities seriously. That may not be the case for all FTSE companies. A non-Big 4 partner stated that evidence identified by his firm might suggest that around ten per cent of FTSE 350 companies were not even aware of FBU. Given that the case companies are largely drawn from the FTSE 100, it might be expected that a degree of reporting excellence would be apparent. One experienced partner suggested that:

I think all of the companies I have been involved with have exhibited good reporting in the past, this has really just acted as a refresher, it has helped them to continue to improve and shorten. So definitely a good thing but I am not sure that the top end of the FTSE 100 is where the biggest benefits have been seen. (AP9)

A senior audit partner emphasised the impact on annual report cohesiveness suggesting that both FBU and the strategic report had resulted in:

> *….a massive impact on reporting quality especially the 'front-half'. What the strategic report and FBU have done is enabled companies to tell a coherent story of what their strategy is, what their business model is in order to execute that, how they measure success in that execution - so non-GAAP measures and KPIs - that then links to how they performance manage or incentivise management and that again to the actual 'back-ends'. We have moved from a position where there used to be at times quite a disconnect between the 'front-end' and the 'back-end' … sometimes if you ripped [several] annual reports in half you couldn't tell which 'front-end' went with which 'back-end' … that is the impact that it has had in my experience.* (AP4)

While no case company acknowledged such major change in their own reporting, there were cases of perceived substantial change. The audit partner quoted above stated that in the case of his own client:

> *There is quite a noticeable change between their 2012 and 2013 reports. But you have got to remember also that there were significant management changes as well. So it is difficult to ascribe exactly what the real drivers were. It is a combination of management wanting to be more transparent and FBU enabling them to do that.* (AP4)

Thus, non-regulatory influences may enhance reporting quality; the comment about being 'on a journey in terms of its reporting' was echoed elsewhere. The financial controller for this group reiterated the partner view:

> *It came as an opportunity to revisit the general flow through the 'front-end' into the back. And so a lot of what we did was more around reordering and making sure there was a nice clean flow through the document … it sets out the strategy more clearly; we have spent a reasonable amount of time looking at the risk section just to make sure that the risks mentioned are specific and not just a long general list; we now have a section up front which focuses in on those that we deem to be critical. We have a slightly broader section now on the global business environment … so overall I guess most of the time was spent revisiting the information that we had already included but making sure that it was structured in a more appropriate way.* (FD4)

Other companies' experiences reflect these examples with restructuring of the 'front-half', opportunities to implement a more conscious process and belief that FBU only represents progress on an existing journey, apparent.

Mostly, individuals do not distinguish between the effects of the FBU and the strategic report regulations; one auditor, however, suggested that:

> *The strategic report gave structure to* [the 'front-half'] *and the FBU requirement gave the transparency and the need to tell a 'fair, balanced and understandable' story. I think they both contributed in different ways. (AP4)*

A non-Big 4 partner, whose comment may reflect a client base composed of relatively small companies, suggested that the strategic report regulation had more of an identifiable impact on the 'front-half' than FBU.

In summary, although most interviewees do not believe that FBU led to a step change in corporate reporting, and specifically as regards 'front-half' content, there is a perception of significant impact in terms of restructuring or representation of the 'front-half'; for example, in order to tell a more coherent 'story'. Perhaps regarded as even more significant was the opportunity which FBU gave for reflective consideration, e.g. by audit committees, as to whether reports were FBU.

Process and audit committees

The role of audit committees in implementing FBU was explored. There was some comment from those representing larger companies regarding the quality of non-executives and their key role as regards FBU. A FTSE 100 finance director commented that:

> [The quality of reporting] *has been substantially driven by the quality of the non-executives and I think* [that] *plays a huge part as to whether or not these reports are 'fair and balanced'.* (AP8)

A senior partner commented that:

> *I have always worked on FTSE 10 companies so I have always seen high quality audit committees who are quite hands on in terms of ensuring that the annual report is a good document. (AP4)*

All companies had established some process involving the audit committee in order to help facilitate their FBU confirmations. The nature of process varied in terms of formality and detail and also the extent to which regulation prompted process enhancement. The largest case company, perhaps unsurprisingly, provided the most obvious case of a structured and documented process. The audit committee chair explained:

> *… each member of the group executive committee had to sign a certificate* [confirming] *… that in their view the annual report when taken as a whole was 'fair, balanced and understandable'. These certificates were provided to the audit committee … we asked the auditors to review the annual report as a whole and they also performed an assessment of the group's compliance with the code and the 'fair, balanced and understandable' test in particular. XXXX* [name of audit firm] *then provided comments to the company secretary; these were included in the draft annual report that was then reviewed and approved by XXXX … and representatives from XXXX were present at the audit committee when we considered the issue of 'fair, balanced and understandable'. We asked the company's external legal advisors, ZZZZ, to perform a compliance and legal review of the 'front-end' … and they, too, provided comments that were considered by the project board and reflected in the document.* (AC4)

Even here, FBU had only enhanced an existing and rigorous process. The audit partner reiterated:

> *… it is a more conscious, more formalised process. But I don't think people are doing anything differently. There is just much more awareness of what needs to be done and of the governance scrutiny that they are subjected to.* (AP4)

As did the group financial controller:

> *… the composition of our audit committee has been such that … we were largely down that road anyway … we have always had debates around making sure that it is balanced … so it wasn't really a fundamental change to make that assessment because much of what we were doing was trying to achieve that anyway*

> *… it didn't require any huge change in process other than explicitly pushing people to make sure they signed up to the fact that it was balanced as well.* (FD4)

While varying in detail and often much less structured than this example, processes were characterised by discussion involving audit committees, auditors and preparers. Generally, the interviewees for each company described how the process worked in a consistent fashion. In one case, the audit committee chair described how:

> *… at the start of each year we will sit down formally as an audit committee and I will certainly do it one to one with* [name of deputy financial director] *… we track new initiatives … new standards, new parts of the code, FBU, strategic report, audit reports … we follow that through in different meetings.* (AC1)

The partner view was similar:

> *I would say* [the audit committee] *have been quite actively involved with quite strong steers to* [name of deputy finance director] *as to what he needs to do, or what way they want to see it going to ensure that they are meeting the objectives of FBU … when we had the significant changes in FBU and the strategic report they saw a draft much earlier in the process than they would previously … there is an appropriate level of input from the non-execs … FBU has brought that much more into focus.* (AP1)

The audit committee chair of one FTSE 250 company exhibited an exceptionally irreverent attitude:

> *FBU … I'll put it on the agenda … the audit committee will just sign it off. But … I wouldn't say it's a big deal … the auditors have all adopted the FBU thing … it's another way to boost their fees … in a sense FBU doesn't mean anything. I think it's a complete irrelevance.* (AC6)

Generally, however, FBU was considered carefully by companies. Formal process for arriving at FBU judgments was often relatively simple. FBU was always considered consciously, however, and typically the process involved several

sequential stages. Thus the impact on the presentation of the 'front-half', together with the necessity for companies to consider FBU consciously, meant that all interviewees viewed the FRC's initiative as a 'good-thing' in terms of corporate reporting.

Impact of FBU on 'back-half'

FBU is essentially a 'front-half' initiative. However, given the FRC initiative to 'cut clutter' (FRC, 2011b), now rebadged as its *Clear and Consise Initiative* (FRC, 2015), opinion was also elicited on FBU's impact on the 'back-half'. Most individuals indicated little or no impact with a few indicating modest improvement:

> *… there were about five or six notes that we moved* [from the 'back-half'] *to an appendix … derivative financial instruments, share based payments … in the spirit of de-cluttering.* (FD2)

This finance director view was echoed by the audit committee chair whose interpretation, however, was less positive:

> *… it's allowed people to push stuff even further back … nobody's taking out stuff yet … the clutter is now supplementary notes or appendices.* (AC2)

In one FTSE 250 company, significant progress had been made in cutting 'back-half' clutter; the principal imperative, however, was not regulation but that reporting quality was a long standing priority. The financial controller explained:

> *Do you see these boxes that are brown? They're not part of the annual report and accounts, they're explanatory boxes that try to explain in very simple terms how the revenue and repayment work on a loan for instance … we've done that for the last three years. I knew the questions that get asked by analysts and investors like 'what does this disclosure mean?' We try and address those things in the back-part already.* (FD7)

Reasons were given why FBU had not impacted positively on the 'back-half'. Occasionally, the nature of the industry, e.g. insurance, is seen as an obstacle to less opaque financial statements. Regulation, however, was viewed as the main impediment:

> *… the IASB, I guess, still needs to do an awful lot in terms of making the 'back-half' much less cluttered; I don't think FBU has driven it in either direction. I think the 'back-half' is all about compliance and there is an awful lot you have to comply with. (AP5)*

Not only did regulation prevent 'cutting clutter'; so did fear of regulatory censure:

> *Companies find themselves in a difficult position - if they try and reduce clutter the reality is … I don't think anyone would admit this … you have got to make some quite aggressive materiality calls. If companies make an aggressive call on what is material they really do run the risk of getting a letter from the review panel saying 'why haven't you disclosed this?' - so they take the easy route and disclose everything … there has to be a recognition from the regulators that '… as long as you disclose what you are doing and what you regard as being material, then we accept that you don't disclose it'.* (AP4)

Thus regulators, and standard setters such as the IASB, may need to actively facilitate initiatives aimed at 'cutting clutter'. The point made above about 'aggressive materiality calls' is noteworthy. The audit chair of a major FTSE 100 company, an executive director in a major fund management organisation, suggested legislation as a way of dealing with the problem of 'mushrooming accounts'. Some interviewees felt that significant cutting of clutter, certainly in the obvious sense of shorter annual reports, was not feasible. One company's initiative in providing notes on technically challenging 'back-half' material, offers an alternative approach; clarification rather than abbreviation. An audit partner suggested a variation on this:

> *I think where you could see some opportunity is by cross referencing* [from the front*] into the back.* (AP5)

Another audit partner linked de-cluttering both with 'understandable' and 'integrated reporting':

> *… perhaps part of 'understandable' for my money is de-cluttering; making it a much more robust and integrated document.* (AP9)

This reinforces the suggestion that more regulatory guidance on FBU may be appropriate. Summarising, FBU appears to have had minimal effect in 'cutting clutter'. Increasingly complex accounting regulation is perceived to inhibit this. Initiatives aimed at clarifying technical material rather than contraction per se, offer an alternative approach to 'back-half' improvement.

Pictorial and graphical content

Pictorial and graphical content was regarded as worth considering by most interviewees including some who had not considered the issue previously. One auditor acknowledged how the draft annual report might be 'signed-off' prior to the inclusion of pictorial content:

> *That is a very interesting point …. at the point when you sign off, often enough the bit that is not in there at all are the pictures. To be honest, that is not something I ever really thought about.* (AP8)

Some individuals did not consider this issue as significant due to the perceived unimportance of such content for them:

> *We're heavier on content and lighter on some of the graphics, which we don't think add much value. You look at this graphic and you think 'wow, that could be anyone in our peer group and we'd rather describe it in words' … and our investors are perhaps more words than visual people … we're very clear that it's not a marketing document.* (FD1)

More typical was acknowledgement that, pictorial and, especially, graphical content was important:

> *… of course you can manipulate the impression given through diagrams and graphs … pictures is harder; the risk of someone coming to a distorted view is much less because they are not trying to portray information in the same way as a graph.* (AC2)

This audit committee chair's view of the importance of graphical content was mirrored by an auditor who indicated that while he probably formed:

> *No significant view in terms of things like photographs and artworks. We do, though … remain concerned about things like*

> *graphs. I think for trend analysis there is a challenge but for photographs and graphics there is less review.* (AP5)

In certain industries, pictorial content could be unfair or unbalanced:

> *… it* [may] *well be the type of client I deal with … it's very difficult to be anything other than factual … but you can see that for certain types of industry your choice of graphics or photographs might well be unfair or unbalanced.* (AP5)

The partner responsible for the FTSE 250 financial services company considered such content specifically:

> *… it probably gets a lot less focus than the words … it is interesting because there are probably subliminal messages in the pictures somewhere … I think it is an area where people still focus on the positives.* (AP7)

The company's financial controller suggested that:

> *We would not try and portray things as though they are not* [true, representative] *… I can't think of examples off hand but there have been lots of cases where we have removed photographs.* (FD7)

Other preparers echoed such sentiments:

> *We need from an FBU perspective to ensure that it doesn't all look fabulous and glossy … because we've had lots of compliments to say that it's very transparent … it's not written as a marketing tool.* (FD2)

The audit chair of a large oil and gas group suggested, perhaps surprisingly, that:

> *If we had had, say, a* [name of a disastrous event] *like* [another large group operating in the same industry] *then I am sure that we would have had plenty of nasty photographs to let everyone know just how serious an event that had been and what the repercussions would be going forwards.* (AC4)

This group considered such content thoroughly:

> *… the drafts that the audit committee considers include the pictures and I think pictures are very important. Again, positive and negative, they allow people who will not be familiar with the detailed workings of the company … to understand what it is we are doing very quickly and often a good picture is a much better descriptor of what is going on than several pages.* (AC4)

Auditors appear to consider such content less than insiders. The audit partner for the group referred to above stated that:

> *I have never actually considered how they choose the photographs that go into their annual report … I genuinely think that they use photographs to illustrate their largest projects.* (AP4)

Thus there is realisation as to how FBU may be affected by non-narrative content and this is considered, albeit informally, when annual reports are reviewed for FBU. Auditors should arguably give more attention to pictorial-type content given its potential for impression management.

Costs

Non-auditors were asked for views as to the costs, other than those relating to audit and assurance, incurred by companies in complying with FBU. Generally, these were regarded as insignificant; certainly in no case were they regarded as invalidating the FBU initiative. In around fifty per cent of cases it was felt that more time was spent on preparation or review, sometimes as part of other initiatives to enhance reporting.

> *I think it was additional to what we were doing already.* [XXXX's] *team would have done a lot of research upfront to make sure that the board had a comprehensive understanding of what FBU required when it was first considered … I think the time involved was well spent and it has informed this year's process … it's good; it is not often I describe additional work as good but this was.* (FD5)

A few interviewees attempted to quantify the additional time:

> *Two extra days for me as audit committee chair and extra time for the members due to more debate on the 'front-end'.* (AC2)

Possibly the most significant costs were suggested by the deputy finance director of a FTSE 100 company who suggested that he may have spent around one hundred hours in total on FBU and on other corporate governance changes. In summary, most internal participants did signal some additional costs but these were viewed as insignificant and well worthwhile in the context of the FBU exercise. Many participants struggled to identify any additional measurable costs.

Investor feedback

While this is not the primary focus of this research the opportunity was taken to identify any feedback received from investors to auditors or corporates on FBU and 'front-half' assurance.

It appeared obvious to one or two interviewees that investors should welcome FBU:

> [The annual report as a whole] *definitely benefits from a 'balanced' view and I think the fact that there is additional assurance on the 'front-half' can only be a positive thing from any user's perspective. I would expect it overall to be seen as positive … users have both a clearer document and improved assurance.* (FD4)

The dominant impression, however, was one of investor indifference; certainly feedback from investors appeared to be lacking. Even the financial controller who suggested that 'front-half' assurance should be viewed positively acknowledged that:

> [While] *there is obviously a range of users, the people I deal with believe much more firmly in the 'back-half', to be honest.* (FD4)

Other individuals signalled lack of enquiry from investors not only on the 'front-half' but on the annual report generally. Several auditors indicated that they received few investor enquiries on any subject. There were a few comments, however, suggesting that investors might be interested in FBU's 'front-half' impact, if not in the associated assurance.

> *Normally the comment you get about the annual report at AGMs is just that it is too long … it is back to the understandable point.* (AP8)

The company secretary of a FTSE 100 construction group suggested that whilst investors were interested in 'front-half' aspects, such as strategy and tone, he doubted whether they were specifically interested in FBU. This reflects other views expressed including reiteration of the argument about professional investors having access to other information. The financial controller of the FTSE 100 construction group commented more positively:

> … [investors] *clearly want* [the annual report] *to be 'balanced and understandable'. I have heard it described as the 'go to' document for any work that they are doing.* (FD5)

There is belief, then, that investors, depending on category, do have some interest in the 'front-half'. However, interviewees were generally unaware of any investor interest in 'front-half' assurance. The audit chair of the oil and gas operator referred to above had, exceptionally, some related contact. A major investor suggested to him at the AGM that:

> ['Front-end' assurance] *was okay but it wasn't top of the pile and the reason why I think … is that Rolls Royce took quite an aggressive view to disclosure and talked about certain things that weren't working very well. They had a change of audit partner at KPMG who had encouraged that and in a sense that became the gold standard for last year … no doubt we will consider that going forward.* (AC4)

The suggestion here is that investor interest in 'front-half' assurance is transcended by changes to audit committee reporting and audit reports. The audit partner reiterated the apparent lack of interest from investors in assurance on not just the 'front-half' but more generally, expressing frustration over their lack of appetite:

> *…. the oil and gas reserves disclosures are the most important in an oil and gas company and are unaudited … if I was an investor I would want these numbers audited … maybe they are saying 'actually no auditor worth his salt is not going to audit it' … so they say 'we are getting that anyway we are just not getting the* [report]*' … shouldn't those really key data be audited? I think the KPIs should be audited, I think all the non-GAAP measures should be audited but there just doesn't seem to be an appetite. The only comments that I have received from investors recently have been over the new audit report.* (AP4)

Thus, there is a view that certain 'front-half' numbers, at least for some industries, do matter to investors and that an apparent lack of demand for assurance is perplexing. This audit partner highlights two factors which may help explain this. First, as the audit committee chair also suggested, 'front-half' assurance may have been trumped by audit reporting developments. Second, investors may believe that the complete annual report is effectively audited anyway. Possible inter-relationships between 'front-half' assurance, changes to audit reports and audit committee reporting, are discussed in the following chapter. The suggestion that investors may view auditors as already auditing the complete annual report was echoed elsewhere; an audit committee chair stated that he attended:

> *… a regular forum where audit committee chairs meet investors … what is fascinating is how investors fundamentally misunderstand … the whole audit thing … they assume there is assurance* [on the 'front-end'] *anyway because, you know, it's the annual report.* (AC6)

The financial controller of the FTSE 250 group with many retail investors suggested that:

> *… most people out there believe that there is assurance on the whole annual report and I would take that view because if I'd written something that was rubbish, I'd want my auditors to tell me … I think people assume that what's in there is fully covered by the auditors.* (FD7)

An interesting point on investor interest in 'front-half' assurance was made by a non-Big 4 partner who headed up his firm's governance unit; he contrasted corporate governance specialists with more 'mainstream' investors:

> *… the well-publicised names are supportive* [of 'front-half' assurance] *… unfortunately when you talk to the analysts … all they want to know is the key stats, where we think the company's going, what the prospects are … so there is a bit of a disconnect still between the analysts and the governance specialists.* (AP10)

In summary, there appears to be little or no investor feedback on FBU. There is some indication that investors are interested in the 'front-half' but, despite

prior research evidence, there is little suggestion of investor interest in 'front-half' assurance. Possible reasons include greater interest in other current audit reporting developments and belief that the complete annual report is already audited.

Summary

- FBU and related regulatory changes, for example, the requirement for a strategic report, are perceived to impact positively on annual reports, particularly the 'front-half'. For some 2013 annual reports, this took the form of enhancing existing initiatives to improve reporting.
- FBU has not impacted significantly on content *per se*, nor led to a reporting step change; rather impact is typically perceived to have consisted of a reordering of content resulting in both the 'front-half' and the annual report as a whole becoming more logical and cohesive. The regulation has also resulted in more reflective and conscious consideration at audit committee level as to whether annual reports are FBU.
- The respective impacts of FBU and the strategic report requirements are not viewed generally as distinguishable.
- Processes established in order to ensure FBU compliance vary; those of larger companies tend to be more formal and detailed. With one possible exception, however, all preparers and audit committee representatives regard FBU seriously.
- In general, FBU has had little impact on the 'back-half' in terms of 'cutting clutter' although there are isolated cases of modest beneficial effects.
- Graphical or pictorial content is perceived to have FBU implications and audit committees and preparers, in particular, consider this, often informally. Given its potential for impression management, however, some guidance from regulators on the FBU implications of such content may be appropriate.
- The cost implications of FBU for companies in terms of time spent on preparation or review are generally regarded as insignificant although there are isolated cases of significant time being invested.
- There is little apparent investor feedback on FBU and the provision of associated assurance. The minimal feedback received does not indicate FBU to be a high priority for investors. The apparent lack of interest in assurance may be due to factors such as the greater appeal of other initiatives including recent reformation

of audit reports and the possible belief that the complete annual report is already audited. The lack of appetite for assurance on selected 'front-half' numbers was viewed as perplexing by participants.

- In summary, the FBU initiative is viewed favourably and when asked directly whether or not they perceived it to be 'a good thing', almost all participants responded positively.

6. FAIR, BALANCED AND UNDERSTANDABLE: IMPACT ON AUDIT

The fourth research question concerns the assurance which auditors are now providing on the 'front-half' and is explored in this chapter. Opinion was elicited as to whether auditors now engage with the 'front-half' differently compared with practice under previous reporting requirements. Areas which auditors find challenging and cost issues were also explored.

FBU: more than consistency?

Views were elicited on the scope of assurance provided under FBU and on how this compares with the previous 'consistency' requirement. The most unenthusiastic comment was made by a company secretary who suggested that:

> *In ninety-nine cases out of a hundred there isn't any value* [to the assurance provided] *because there's never going to be any need to report on an exceptional basis.* (AC5)

Offered by an individual with a legal background, this view questions the value of any audit reporting by exception.

Some individuals implied that not much had changed from the previous 'consistency' regime. One finance director suggested that that the value of the 'front-half' assurance provided was negligible and a financial controller of a FTSE 100 insurance provider did not distinguish responsibility for making FBU judgements from the associated assurance:

> *I think modest is the phrase I would use* [to describe the assurance] *because I'm very clear about who is responsible for making these 'fair, balanced and understandable' judgements - we are … and they should be* [made] *without any intervention from our auditors. Our auditors are always a check, but our objective has to be* [to get it] *perfect. Does* [the assurance provided] *make a big difference? Not really and has there been a big step change from where we were before on 'consistency'? I don't think so.* (FD3)

These comments reflect those of the audit partner who suggested that the essence of the 'new' requirement was:

> *… not materially inconsistent with knowledge acquired in the course of the audit. I don't perceive us as being required to go on an extra 'fishing trip' but clearly we need to have read the 'front-half' and to make sure we've understood what's being said.* (AP3)

These and similar comments appear to indicate that not much has changed in respect of the 'front-half' assurance provided.

Auditor engagement with 'front-half'

Perceptions of the limited assurance provided was reinforced by one or two individuals conveying a sense of auditors' limited ability or willingness to engage with the 'front-half' One audit chair suggested that while assuring by exception may not have been 'an enormous step from 'consistency' … there is a new test, there is a new hurdle but they struggle to understand it'.(AC2) The financial controller of the FTSE 250 financial services company, which explicitly aims to prioritise excellent corporate reporting, was also critical:

> *I don't think auditors these days have the pride or investment in this document that they should … one of my biggest bugbears is the lack of input into this document as a whole by the auditors … I think they just sort of more or less tick the numbers … they're more focused on some disclosure in the 'back-half' than what it's all saying and doing.* (FD7)

This individual, a former Big 4 audit manager, did acknowledge that his audit partner was 'very good' in terms of industry experience. The deputy finance director of a FTSE 100 financial saw 'front-half' audit work reflecting a compliance driven environment:

> *There is a divergence between what auditors are doing … and how as a company you're trying to connect your numbers, your strategy and a long term view, and I'm not saying that we do that particularly well; specifically in terms of the long term view,* [but] *that is very different from what auditors are getting pushed to do to make sure they've got the right documentation on their files; sometimes auditors have got a very narrow technical compliance*

outlook … the bits you're trying to push out in the 'front-half' are not the bits that auditors naturally look at. (FD1)

This preparer also expressed confidence in his audit partner who, however, appeared to echo the preparer view:

Nothing has changed from an audit point of view, in terms of what I or my audit teams do … I think FBU has enabled us to probably be slightly more challenging. Does it mean that I do lots of additional audit work on the 'front-half' of the accounts - no. We do a reasonable amount, anyway, in terms of making sure numbers are consistent … but I don't do actual audit work on the numbers on the 'front-half', unless they are numbers that appear in the 'back-half'. (AP1)

Thus, auditors are perceived to be reluctant to get involved with 'front-half' aspects regarded as important by 'insiders'; this reflects some auditors' comments. There was, however, also much more positive comment. Even the partner who indicated that assurance work had not changed, acknowledged instances where she had told the client that 'I don't think this is 'balanced'; I think that you need to add something else'. (AP1)

A non-Big 4 partner suggested there was incremental value in a more direct focus on the 'front-half' with FBU, albeit by exception, imposing a degree of 'front-half' proactivity:

… previously the direction of testing was probably based on the knowledge you attained in auditing the 'back-half' and what you were required to do on the 'front-half' was to ensure consistency with [that]. *The direction has now changed … is what is reported in the 'front-end' in its entirety consistent with all your knowledge and presented in the most appropriate way? You start with what is presented in the 'front-half' and test that.* (AP6)

Most auditors may not see it thus, with a Big 4 partner suggesting that assurance under FBU continued to be:

… based on the audit work that you perform on the financial statements … you start with that … and then you're comparing

what you're aware of based on that with what's said in the front. (AP3)

A rather different perspective is illustrated by a FTSE 100 finance director's comment which stressed the evolving nature of audit practice in this area for larger FTSE companies. This finance director's comments supports the argument that in the case of leading auditing firms, practice leads standards rather than the other way around (see e.g. Pong and Whittington, 1994):

> *Even before FBU came in the engagement partner would … pick up on one or two things: 'can we emphasise this or do that?' Maybe they go through it in a bit more detail but I think they more or less have always done it over the last five or six years.* (FD9)

There were other comments suggesting that auditors 'anticipated' FBU.

> *I think the better auditors were* [already] *intrinsically looking for fairness and balance … they never described it as 'balanced'; they just asked 'is this really what you should be saying … and have you got the story right?' I think what this has done is just put a process in place to make sure that they do this … I think it has improved people's clarity of thinking about how you do this so I would argue it has had a positive impact on the audit process.* (FD8)

While, therefore, there are perceptions of auditors' unwillingness or inability to address the 'front-half' aspects which really matter, these are balanced by more positive sentiment. There is a strong sense that meaningful 'front-half' engagement is facilitated by FBU enabling more robust auditor challenges. A partner who suggested that 'front-half' work had not changed, nevertheless stated that FBU had 'probably enabled us to be slightly more challenging' while a financial controller suggested that auditors 'now have more legitimacy in reviewing the 'front-end'' adding that she had found that a 'helpful and efficient process … particularly when it comes to the 'balanced' aspect'. (FD5)

A financial controller responsible for drafting the 'front-half' for a FTSE 250 financial services group enjoyed similar 'clout' as a preparer:

> *'Fair, balanced and understandable' provides a hurdle which is very helpful … if there is something that I feel quite uncomfortable*

with in the 'front-half' which I think is not misleading, but perhaps not the whole truth … it is now much easier for me at an audit committee meeting to say 'this, this and this item I feel uncomfortable with because I don't think they meet the 'fair, balanced and understandable' categorisation'. (FD7)

While there was no general sense of an assurance step change, the audit partner for a large oil and gas group perhaps conveyed the greatest individual sense of this:

I think there is a lot more assurance. I think that with the 'consistency' requirement, what we used to do was to audit every number and assertion that was in the 'front-end' … although it's supposedly unaudited, I would look pretty stupid if an annual report went out and the 'front-end' was full of mistakes. So we audited every assertion and every number. But I am not sure that we really spent the time that we do now standing back and saying 'does this tell the right story?' That is where the strategic report comes in because there generally wasn't a requirement for companies to tell the story and a lot of companies didn't. I think what has happened is that companies are now much more focused on telling the story and that gives us much more of an opportunity to say 'is this story which the company is telling 'fair, balanced and understandable'?' … previously … we didn't have the teeth to be able to challenge. (AP4)

Another auditor was:

Not sure that we have a higher level of risk or obligation in reporting on 'fair, balanced and understandable' versus 'consistency'. We are not signing an opinion on the 'front-half'. However, I think that FBU has increased our ability to influence what management put in the 'front-half' very significantly. To say the 'front-half' is 'consistent' with the 'back-half' is very, very vague and you could argue almost that all that 'consistency' means is that any of the numbers in the 'front-half' just simply need to be the same as the numbers in the 'back-half' - so we have much greater ability to influence and correct. (AP8)

Another change suggested by one auditor was that companies now looked to their

auditors for assurance on the adequacy of their internal processes for ensuring FBU.

Summarising, FBU's impact on auditors' 'front-half' work might arguably be regarded as modest with perceptions that auditors' 'front-half' engagement has not changed significantly as a result of FBU or that auditors are not fully equipped to engage with the 'front-half' meaningfully. Where auditors' 'front-half' engagement is perceived to have increased, this is often as an evolving process with auditors anticipating FBU in advance. Nevertheless, the extra 'clout' or ability to challenge companies, which auditors are perceived to enjoy as a result of FBU, is perceived to be a significant enhancement of assurance.

FBU and other audit reporting initiatives

A more subtle form of assurance enhancement has resulted from interaction between three concurrent initiatives - FBU, revised audit reports and audit committee reporting. FBU allows a more conscious framework for discussions with audit committees or for risk assessment; thus benefits go beyond 'front-half' assurance *per se*. The partner for a FTSE 100 energy equipment and services provider suggested that:

> *I think it has made for a much more engaging discussion with audit committees around a whole suite of things … you have a much more engaged discussion about risks, what the board and audit committee's view is, you're then able to … look at that in the context of what the company has said in its 'front-end' and how it's summarised those risks and then have that put into our audit plan and then discussed in the new form audit reports. I think that what companies are doing differently is that they're probably thinking a bit more deeply about the linkages between business risk in an overall sense, what the financial consequences of those business risks are, how these then translate into areas of greater audit risk and how all of that gets described. That is not new … but I think it has put it more into relief and enriched the conversations.* (AP2)

Another auditor suggested that the various initiatives:

> *… are intertwined … I think that's helpful and there is quite a lot of work done to make sure that we have either a consistent*

> *view of risk or where we don't that we understand and explain why … it's caused us and clients to have conversations that links all the different bits that talk about risk so the 'front-end', audit report, critical judgements … looking across all these and the audit committee report.* (AP7)

Linkages between different reporting developments were also highlighted by non-auditors:

> *Bearing in mind the risks which the auditors would have had to identify in the audit opinion, they would have paid particular attention this year in ensuring that the risks which they had identified were adequately documented in terms of how we addressed them in the audit committee report, in terms of how they were dealt with in the various meetings and, effectively, that* [both] *the front and back adequately disclosed information.* (FD5)

Things done differently by auditors and specific challenges

No auditor highlighted FBU issues which they had found challenging. A few preparers did suggest such issues. A financial controller stated that:

> *From the auditor perspective it's much more judgemental and I think* [therefore] *that it is more difficult for them to apply … that clearly takes them away from the hard and fast rules-based approach.* (FD5)

A FTSE 100 CFO highlighted 'front-half' aspects where she considered auditors might struggle:

> *… where we are using* [sic] *some sort of forecast or we're speculating on what we hope will be the case in the future, I think it's really difficult for the auditors to second guess us … we can compile data to suggest that by 2020* [company specific information] *… XXXX* [audit firm] *can look at our file that supports the* [YYYY] *but they can't go and revalidate it because it would take them the next six months.* (FD4)

Another finance director did not view FBU as challenging for auditors but suggested this was:

> *… partly because of our history and partly because we are regulated … we've always had to be very balanced because if we weren't we'd get tripped up by our regulator … we've always been pretty rigorous.* (FD8)

It is perhaps consistent with these perceptions that there were few examples highlighted of discussable matters between companies and auditors. The finance director of a FTSE 100 energy provider was one of only a few participants who did so:

> *You maybe take impairment on an asset and there is some kind of discussion. How hard do you want to be on that impairment? I am always forward-looking … these assets are still generating electricity … but that is probably the only area where we have had any discussion with the auditors.* (FD9)

This example also unintentionally reinforces perceptions that auditors are over-focused on accounting, rather than commercial, issues suggesting that little may indeed have changed in terms of assurance. The fact that very few examples of contentious, or even discussable, matters were offered by interviewees may also reflect both already high standards of reporting in the case companies and existing good relationships, often of long standing, between auditors and client companies.

Auditing the numbers?

A straightforward way of enhancing assurance may be to do more work on 'front-half' numbers. These may be: financial numbers which also appear in the 'back-half'; financial numbers, e.g. non-GAAP measures, which don't appear in the 'back-half'; or 'non-financial' numbers or KPIs concerning corporate dimensions such as customer relationships, employees, operations or supply chains. There is some suggestion of additional work on 'front-half' numbers although this varies. One Big 4 partner, when asked if he verified all 'front-half' numbers, replied:

> *Yes, we have always done that … clearly we don't sign off on that but as a firm we have always done that, going back twenty years.* (AP8)

This partner explained that by this he meant the non-GAAP financial 'front-half' numbers and his position appears representative of auditors generally. 'Non-financial' numbers are more problematic with some auditors indicating more was now done on these:

> *In terms of the 'front-end' now we make sure that they're 'right' if they've come from the financial statements; if they're management information - so something relating to customer growth - we would check that back to a set of management accounts but we wouldn't audit it.* (AP7)

A partner from another Big 4 firm stated that while numbers which appeared in the 'back-half' were audited, for those which did not:

> *We ask: 'Where has this information come from? What system does it come from?' But we don't necessarily go back into that system.* (AP3)

A non-Big 4 partner suggested:

> *In terms of the nature of the work, I think there are two elements … the first one is around obtaining evidence to support the non-statutory disclosures in the 'front-end' … whether … numerical or … commentary … on* [for example] *potential developments relating to underlying investments … we apply a level of scepticism to comments which are not directly pulled from the audit work that we have undertaken on the financial statements … but then they make some forward-looking statements around those investments. So our work extends to making sure … these are consistent with what is out there in the market … we make sure that we can verify these either to something provided by* [name of company] *themselves or an external search.* (AP6)

A Big 4 partner indicated how verification of 'non-financial' 'front-half' numbers might:

> *… depend on the company and what they have asked us to do. Some companies will ask us to check some of that stuff. I think there is a fair variety of* [approaches]. (AP9)

A non-Big 4 partner suggested that as far as 'non-financial' numbers were concerned:

> *… we spend less time looking at them in all honesty* [although] *if I see stats in there that don't look right I will raise them with management and my team.* (AP10)

Thus, there may be uncertainty as to precisely what assurance work has been carried out on 'front-half' numbers particularly 'non-financials'. The deputy finance director who was critical of 'front-half' audit work was unconvinced:

> *… they may have done more work on a 'non-financial' KPI … sometimes they create confusion as to how much they're doing … it's maybe a little bit more but part assurance that you're not clear on.* (FD1)

Costs

Incremental assurance costs are largely viewed as insignificant. Most individuals indicated incremental costs of, at most, well short of five per cent. There were comments suggesting any increase in costs was difficult to quantify because of other factors, such as changed audit committee reporting, audit reports and 'back-half' changes.

> *It clearly takes a bit more time and effort for everyone including the auditors to go through the 'front-half' … whether that gets translated into specific additional costs, I suspect is problematic.* (AP1)

Only one individual, an auditor, suggested that additional costs might be significant, suggesting that FBU had probably added 'north of five per cent to the costs of the audit' for the case company and that, generally, 'five per cent would be a minimum increase … and, depending upon the level of detail, it could be ten per cent'. (AP6)

Summary

- FBU is not viewed generally as having led to a step change in auditors' 'front-half' responsibilities and the assurance provided. Some individuals believe that auditors' responsibilities are similar to those applying under the 'consistency' regime. Others believe, however, that 'better' auditors effectively anticipated

FBU and there are also perceptions that significantly enhanced assurance has resulted from the new regulations.

- FBU is perceived to provide much stricter criteria for auditors to apply when opining, albeit by exception, on the 'front-half'. Auditors are viewed as enjoying much greater legitimacy and 'punch'.
- A more holistic enhancement of assurance is seen to result from the interaction of FBU with other developments, such as revised audit reports and audit committee reporting.
- More attention is paid to 'front-half' numbers especially 'non-financials' not appearing in the 'back-half' and unverified pre-FBU.
- There is no sense that auditors found issues which were challenging to deal with under FBU; this may reflect existing good reporting by case companies. Incremental costs are viewed as insignificant, at less than five per cent.
- There is a perception on the part of a small minority of non-auditors that auditors have struggled to engage with the commercial aspects of the 'front-half' meaningfully with their work on it reflecting an accounting and compliance-orientated perspective.
- There is no particular consistency of view on the part of either auditors from the same firm or individuals 'representing' a particular company.

7. FAIR, BALANCED AND UNDERSTANDABLE: UPGRADING ASSURANCE?

The fifth research question investigates the perceived desirability and feasibility of upgrading the assurance provided under FBU to enable the provision of a positive opinion. The views of participants on this issue are explored in this chapter.

Positive assurance - technically possible?

There is no strong appetite for positive 'front-half' assurance. There is widespread opinion that some positive assurance, at least on certain numerical content, is technically feasible. However, this is tempered by reservations due to factors such as conflation of auditor and managerial judgements, litigious risk, inability to opine on certain content, the implications of revised audit reports and modest investor demand.

One Big 4 partner while cautious about positive assurance acknowledged that:

> *... there will be portions of the 'front-half' on which you can provide positive assurance. If you look at the directors' remuneration report, there are elements capable of independent measurement ... I think it's much easier to do when the auditor is giving assurance over specific numbers but where it talks about what the remuneration committee is trying to achieve ... then I think it would be really difficult. If you apply that to other elements of the 'front-half' I think you're going to be in the same situation ... I think you can continue to give negative* [sic] *assurance but to give positive assurance I think is a step too far.* (AP5)

This represents the views of a significant number of individuals; i.e. that positive assurance on some, not all, 'front-half' content is possible:

> *... there is quite a lot of interesting information* [in the 'front-half'] *of a quantitative nature ... barrels of oil, for example, or assets under management ... the investment community are really interested in these things ... but I draw a distinction between that and total assurance.* (AC1)

If they're historic and measureable KPIs that are business critical then you can give [positive] *assurance on them.* (AC2)

It's where you can objectively support the numbers as opposed to … very difficult … objectively supporting some of the words. (AP5)

Some participants highlighted areas where positive assurance might be theoretically possible but where cost or technical considerations made this problematic:

Forecasts would clearly be one. You could comment based on experience but … there may well be constituent elements which are quite technical in nature and subject to operational judgement, experience, manpower … and where either it would be very difficult or impossible to do at a reasonable cost because you'd have to bring experts who are as competent as the people who are making the judgement. I think you get into a law of diminishing returns … you cannot assure the future. (AP2)

One auditor visualised such content as neither suitable for complete positive assurance nor so subjective that only reporting by exception was viable. Assurance over process was possible:

In a lot of areas we would have to look at the controls and processes that the company operates as opposed to saying 'that statement is so true that we provide positive assurance on it' … we would say 'well the company has gone through a process of putting together a budget … we are comfortable that they have taken an appropriate approach'. (AP1)

Another FTSE 100 finance director, sympathetic to extending assurance, summarised the problems with forward-looking information:

Auditors are going to opine on a set of assumptions … my assumptions may be different from yours and who knows whether you're right or I'm right … assurance on these things is inevitably different … but the risk is that people think they're exactly the same … fundamentally you can't have the same information about the future than you can about the past. (FD8)

One financial controller distinguished between shorter and longer run forecasts:

> *If you are giving a reasonably short-term outlook statement I think that is something which is easier for them … if you are looking six months ahead you have got reasonable visibility but the reality is that in recent years nobody had sufficient visibility.* (FD5)

One or two individuals highlighted the FRC intention to require boards to include viability statements within strategic reports with the intention to provide improved and broader assessment of long-term solvency and liquidity. It is expected that these statements will cover periods significantly longer than 12 months. While auditors' present obligations in terms of the strategic report do not involve the provision of positive assurance, FRC intentions concerning viability statements may signal possible moves towards this.

Summarising, while positive assurance on certain 'front-half' content is viewed as technically feasible, for example historic KPIs and other numerical content, where assurance on more challenging content is seen as possible, such views are sometimes significantly caveated.

Generic objections to positive assurance

Content-specific reservations such as those highlighted in the previous section were reinforced by more generic objections to providing positive assurance.

Litigation

The negative litigious implications of positive assurance were highlighted by auditors juxtaposed with suggestions that relaxing existing arrangements might lead to more adventurous assurance.

> *As soon as you go into the future stuff … I think the litigation environment would be horrendous … we test the known … the unknown is difficult.* (AP3)

> *I think that if we had some sort of limited liability we would provide substantially more assurance … we could provide much more value to the capital markets … I do find it amazing that directors feel it's appropriate for them to limit their own liability but not to limit the liability of their auditors. (AP4)*

Business understanding

The deputy finance director of a FTSE 100 financial, despite confidence in his own audit partner, did not believe that auditors understood business adequately:

> *We're looking more at the strategic type material … if you say 'my business line A is progressing well' we're away from financials … 'my long term outlook is better and that is really when you meet investors'. That is the type of stuff* [investors] *are interested in … the analysts are able to meet a number of companies in the sector and weigh up the credibility of these … can auditors do that? … it's not just about financial aspects.* (FD1)

It became apparent that concerns about auditors' business understanding and their consequent ability to opine on the 'front-half' were widely-held when opinion on auditor skills and training was elicited.

Conflating managerial and auditor responsibilities

Potential conflation of management and auditor responsibilities was highlighted with the audit chair and audit partner for one FTSE 100 group making substantially the same point; the latter nevertheless suggested that extended assurance was inevitable:

> *Positive assurance would lead to the auditors running the business, if you're not careful. On one or two occasions I had to tell the auditors that they're my accounts not yours … if they're giving positive assurance* [the accounts] *start to be co-authored.* (AC2)

> *I think there is a real risk we start to muddy the water as to who's responsible for the judgements. The auditors are responsible for taking a view on the application of those judgements in the context of the truth and fairness of the annual report as a whole, but I think you could end up in a position where people are focusing too much on what the auditors are saying as opposed to why management is making those judgements. … I think we're clearly on a journey here.* (AP2)

Another reservation was that auditors opining positively on the strategic report would imply approval of corporate strategy. Such reservations, however, do not distinguish between auditors managing clients' businesses and challenging management on 'front-half' content or tone. A financial controller, an ex-auditor, did recognise this difference. Disagreeing with the proposition that positive assurance implied colonising management territory he argued:

> *It's basically challenging management and saying 'well, if you think this, prove it to me' … you're not managing the business, you're just saying* [for example] *'I can read this* [in the 'front-half'] *but in your* [internal] *audit report you've said '… it's a nightmare and we're having to do this'. Why are you not saying that here? …* [the auditors] *can read a 'front-half' and ask 'based on everything that I've come across, does this make sense?'* (FD7)

Thus, both considerations as to auditors opining on particular content as well as more general considerations combined to ensure there was no general will in favour of positive assurance.

Overall positive assurance

The financial controller who argued that providing positive assurance would not mean auditors encroaching on managerial territory was one of several individuals who envisaged no significant obstacles to full positive 'front-half' assurance.

> *They should be able to do so providing they're engaging with management throughout the year … I think it's a bit more difficult if you come in once a year but clearly that's not how you should manage an audit relationship.* (FD7)

This opinion was very much a minority one as far as non-auditors were concerned; auditors, however, were often surprisingly enthusiastic about positive assurance. The most confident was a senior Big 4 partner:

> *I have an interesting debate within my firm … we are giving negative assurance on FBU … so as far as I am concerned I am giving* [positive] *assurance on FBU because I am required to make a statement if I don't think it is 'fair, balanced and understandable' so by default I am saying that I think it is … based on the work that I have done I believe that this is 'fair, balanced and understandable'*

> *is in my view exactly the same as being required to say if it is not. So I don't see a difference between negative[6] assurance and positive assurance really … we need to believe that the opinion we are signing is based on the knowledge that we have obtained during the audit … we believe it is 'fair, balanced and understandable' and that is the mind-set with which I tell my staff to look at this stuff.* (AP4)

This very experienced partner believes there is no substantive difference between positive reporting and reporting by exception. This view, however, was not general. This partner's approach to the 'front-half' appeared exceptionally thorough; he suggested that although the 'front-half' was:

> *… supposedly unaudited and so on,* [he] *would look pretty stupid if an annual report went out and the 'front-half' was full of mistakes … so we audit every* [financial] *assertion and every number.* (AP4)

> *FBU gives us much more of an opportunity to say 'is this story which the company is telling 'fair, balanced and understandable'?'* (AP4)

He further suggested 'we could give positive assurance on KPIs, on non-GAAP measures and on all the sort of stuff which you would think stakeholders would want' (AP4). It was a relatively small step for this partner to visualise full positive assurance. The other partner from the same Big 4 firm was much less sanguine; for auditors:

> *… to get themselves comfortable with the strategic intent of the client is almost impossible … where you enter into* [subjective areas] *I think it becomes very difficult to give a positive view because it's in the eye of the beholder. (AP5)*

There is no apparent 'firm-effect' in respect of auditor views on positive assurance.

A partner from another Big 4 firm also exhibited a favourable attitude to positive assurance:

> *I think as a firm we would probably be happy to say that this is what we have done on the 'front-half' and this is why it is FBU*

> *… FBU means different things to different people … but if we can describe what we've done I don't see what we shouldn't be able to say whether we are entirely comfortable with it or not.* (AP9)

The second partner interviewed from this firm, whilst more restrained, suggested that:

> *… it would be desirable to give a positive opinion. There is a lot of information in the 'front-half' which is actually very important … to be able to give positive assurance on it would require a lot more work … there are certainly aspects of the 'front-half' on which I think it would be desirable to have positive assurance … I suspect there are examples for all industries which would be well received by analysts.* (AP1)

No partner from the other two Big 4 firms exhibited attitudes on positive assurance comparable to the two most favourably disposed partners (AP4 and AP9), although one was optimistic as to the possibilities for positive assurance while unconvinced on its usefulness:

> *I think the profession has always been far too reticent on giving opinions on things … so much of this is driven by litigation risk … personally my view is that there is lots and lots of stuff that we can give opinions on … could we give an opinion on the 'front-half'? … absolutely we could, as long the standards on which that is based are clear. The issue though is anyone bothered?* (AP8)

The view that a clear framework would be a necessary prerequisite to positive assurance was echoed by other auditors, including the partner (AP9) who emphasised that perceptions and interpretations of FBU were inevitably individual. The view that there was no apparently strong investor opinion in favour was also expressed by other interviewees. While audit partners varied in opinion as to how far assurance on the 'front-half' could or should be extended there was a general sense that the inevitable direction of travel was towards more. Of the two partners interviewed from non-Big 4 firms, one did not favour positive assurance:

> *… the emphasis has to remain with management because it's their accounts, they're the ones who understand the business … not us*

> *… it's easier* [to express a positive opinion] *on the back … because you have very specific accounting standards. (AP10)*

The other again highlighted the importance of a framework:

> *… if an appropriate framework could be established that was very clear in terms of the level of work required in order to give a positive opinion then I don't think it's beyond the wits of an auditor.* (AP6)

These views are again personal rather than corporate. In summary, while few non-auditors favour overall positive assurance or believe that it is possible, auditors are generally fairly optimistic. There is, however, little perceived investor demand. Even the partner who was most positive on positive assurance acknowledged that 'it is not clear that there is an appetite … investors may think that we are doing it anyway' (AP4). Although very much an exceptional view, the considered opinion of one auditor that there is no substantive difference technically between reporting positively and by exception, is interesting and might merit further research exploring the views of auditors and others on this issue more generally.

Costs

Views were elicited on the likely costs of positive assurance. The most common responses were that incremental costs would be significant, impossible to quantify, or that estimation was impossible. One or two individuals suggested that a near doubling of audit fees might result. Some who minimised the difficulties argued that incremental costs would be very low. The FTSE 250 financial controller who firmly believed that auditors could provide 'front-half' assurance relatively easily suggested incremental costs of five per cent while the audit partner who exhibited the most favourable attitude towards the provision of 'front-half' assurance:

> [Did not] *…think it would add a huge amount; the only thing it would probably do is to involve more senior time but … probably not even five per cent.* (AP4)

Summary

- While interviews did not indicate a strong appetite, generally, for positive 'front-half' assurance, there is fairly general recognition that this is at least partially possible.

- 'Front-half' financial information, including non-GAAP measures, is the most obvious such content for positive assurance; historical KPIs are an example. Auditors' perceived ability to opine on other 'front-half' financial information, e.g. forecasts, was significantly caveated. Such sentiment was juxtaposed with some interviewees highlighting the possibility of more onerous obligations in respect of forward-looking information being placed on auditors as result of FRC proposals requiring companies to produce forward-looking viability statements.
- Significant reservations regarding overall positive 'front-half' assurance concern auditors' ability to engage meaningfully with subjective 'front-half' content or the appropriateness of them doing so. This reflects concerns about the business understanding, or orientation, of auditors. There are also concerns about conflating auditor and management responsibilities. Other perceived obstacles include potential litigious implications.
- There is an alternative view, held particularly by some auditors, that it would be relatively straightforward for auditors to provide positive 'front-half' assurance; this is tempered by acknowledgement that strong investor demand is not apparent. Auditors themselves are sanguine on providing positive assurance. A minority are enthusiastic while others envisage a gradual and inevitable extension of the assurance presently provided.
- Some participants, particularly auditors, are more cautiously optimistic, emphasising an agreed framework as a necessary prerequisite to the provision of positive assurance.
- Upgrading the 'front-half' assurance provided to that of a positive opinion is seen to imply significant costs although, perhaps unsurprisingly, those who are optimistic about the technical feasibility of doing so tend to envisage likely incremental costs as relatively modest.
- There is a discernible difference in the views exhibited by the different interviewee categories on positive assurance. Auditors themselves are the most favourably disposed towards the provision of positive assurance and the most confident in terms of their ability to provide this. A small minority of preparers are also strongly in favour of positive, or at least, more adventurous, assurance.

8. AUDITOR SKILLS AND TRAINING: NEW SKILLS REQUIRED?

The sixth research question and this chapter explore auditor skills and training in the light of FBU and other possible developments. The opportunity was also taken to elicit opinion on the future scope and characteristics of assurance.

Auditor skills and FBU

Auditors are not perceived to require new skills in order to engage with FBU; the principal reason is that FBU is typically the preserve of the engagement partner and other auditors operating at senior levels. The requirement for such auditors to be experienced, rather than to possess more specialist skills, was emphasised:

> *Are we needing to have* [new skills] *as a result of FBU? I'm not sure we are. We are responding to what we believe are the significant audit risks … that's what we've always done.* (AP2)

> *I think that the most important element in assuring on FBU is experience because there is so much judgement involved. There is not a tick list of 'as long as you have done x, y and you will have achieved FBU'.* (AP1)

> *It is the partners who are making the FBU call and are doing all the work … we have a whole team of people looking at different parts of it but it will only be two or three people taking a view* [on all of] *it.* (AP4)

Some audit partners suggested that FBU had required auditors to review the annual report 'with a different mind-set' but that this had been unproblematic:

> *It probably requires more of a commercially minded approach but I don't think it's something that has needed a lot more training and development.* (AP7)

Preparers or audit committee representatives do not believe that auditors have had to become familiar with a broader skill-set in order to engage with FBU but

there are perceptions of tensions between technical accounting and broader requirements:

> *Auditors probably need broader skills these days but unfortunately the technical side of accounting has become more technical.* (FD8)

It became apparent that such sentiments were relatively widespread when views were elicited on general auditor skills and training.

Auditor skills and training

There is a fairly widely-held perception that while auditors possess excellent technical accounting skills they can be insufficiently business-aware. Some auditors themselves, particularly more senior partners, acknowledge this. One preparer highlighted concerns about compliance:

> *The behaviour of auditors is increasingly influenced by their regulatory bodies … everything is becoming a compliance exercise … common sense sometimes flies out of the window.* (FD1)

There are particular concerns regarding more junior auditors, both because of their lack of business experience or comparative naivety and the influence of the regulatory environment. One FTSE 100 CFO suggested that junior auditors:

> *… don't have business experience … I don't think that you train scepticism … I think that you experience scepticism as a business person … I think it is a real challenge …. they're bright young people … it's not their fault but they become hung-up on box ticking and checklists … the only person who asks me any probing questions is the audit partner, one individual … it's all about compiling a file to say 'I've got a file note from XXXX* [name of CFO] *to say she's looked at ZZZZ'.* (FD2)

An audit partner nearing retirement suggested that that while junior auditors were:

> *… incredibly bright people … they get disenchanted really quickly because any element of flair is driven out of them by an intensely compliance and regulation driven environment … they sit on their laptops and* [while they might speak to clients] *it's a very compliance-led and narrow conversation.* (AP3)

One or two vigorously expressed comments targeted not just junior auditors. A financial controller, and ex-auditor, suggested that:

> *In the case of the partner, director, senior manager there should be more engagement with what's going on in the business … I still think there's more focus on an accounting policy or on how you account for things rather than on how you're communicating your business … they come in and ask about it … but I think they're doing that thinking 'oh, that might be an accounting issue'.* (FD7)

Despite this, this financial controller was satisfied generally with his own auditors and complimentary about the engagement partner.

Summarising, there is no strong sense that auditors have had to become familiar with specific additional skills as a result of FBU. This reflects a view that FBU is the province of more senior auditors and that the necessary qualification is the experience possessed by such individuals. This was juxtaposed, however, with a view that, while technically excellent, auditors, certainly those more junior, lacked business awareness.

Future of assurance

Views were elicited as to the future development of assurance. One or two individuals envisaged major changes to assurance; one Big 4 partner did not envisage:

> *… a position where in ten years' time we shall still be producing backward-looking audit reports. I think that we have to get our heads around that as auditors because we are so risk averse.* (AP1)

A few individuals envisaged real-time assurance developments:

> *I think that you could potentially see a situation where much of this stuff* [i.e. corporate and audit reporting] *is on a website. And then you get real-time assurance … on certain key KPIs which actually are relevant to investors.* (AC1)

> *… appetite for information on a real-time basis is huge … if people are going to start putting out more real-time information one of*

the challenges and opportunities for us is to look at how we get that assured. That's a very different type of assurance. (AP3)

Some individuals envisaged that IT centred developments might facilitate more routine assurance work being executed with minimal human intervention, thus freeing auditors for more business-orientated roles. One auditor suggested that:

My vision for the future is that if I was to audit XXXX [name of client] *in twenty years' time I'd have a bunch of smart people who understand business and the key judgements and I'd have a machine that assesses the systems … the profession has to find a way of doing assurance work on an IT rather than a manual basis because the manual is prone to error … it's dependent on the quality of the people and if you can't make it interesting quality will go down.* (AP3)

The need for auditors 'to understand business' was linked with 'front-half' assurance, sometimes on forward-looking information:

I think that it would require quite a different style of training from that which the accounting profession does because it's closer to the academic style. (AC2)

I've learnt enormous amounts but it's through understanding businesses, understanding risks, having access to client levels way above my experience … I fear that people are more concerned with documenting stuff better … re your point about an auditor giving an opinion on the future … I don't think that they have the skill set to do that because I don't think that's why we train them … because we don't; we're training them how you document stuff better. (AP3)

Thus, it was recognised that a greater 'front-half' focus in the future may require reformed auditor training. There might be a need to experience business directly:

… maybe secondments into industry should be more common … so you understand more about what's going on …. another thing that nobody ever does is actually to review analysts' notes … what analysts are writing about regarding the company, what are they

> *talking to shareholders about, what are the key issues out there in the market because that's clearly what's challenging management and what's challenging management will feed its way into the numbers and how you portray yourself.* (FD7)

This former auditor highlights a perceived deficiency in the evidence auditors examine. His comments reflect his experiences as a client of two Big 4 firms. A different 'improvement' suggested was multi-disciplinary audit teams:

> *… if we are talking about large, complex, multi-national audits … I think that we need to have multi-disciplinary teams of engineers, mathematicians … there is a huge amount of the audit that involves financial modelling; a huge amount of the audit involves valuations and actuarial stuff … the way we currently proceed is to take graduates from any background and teach them to be chartered accountants, beating out of them everything they might have learnt at university that is relevant … they come in as these audit clones. I just don't think that is the way forward.* (AP4)

Summarising, radical changes to assurance envisaged the end of 'backward-looking' audit reports; a more modest anticipated change to future audit reporting was envisaged through the development of the revised 2012 audit report. Assurance developments making more use of contemporary IT capabilities included emphasis on 'real-time' assurance as a means of facilitating more business-orientated assurance.

Summary

- The assimilation of new skills by auditors in order to engage with FBU is viewed as unnecessary. The essential prerequisites are viewed as experience and a more business-oriented approach; partners and other senior auditors involved with FBU are largely believed to possess such attributes.
- There is a strong element of opinion which believes that junior auditors lack business nous. This reflects lack of commercial experience, the contemporary compliance-driven environment and emphasis on technical accounting rather than business awareness.
- One or two individuals suggested that such limitations go beyond junior auditors to those in more senior positions.

- A future move towards greater 'front-half' assurance, particularly on forward-looking information, will require more business understanding.
- Suggested ways of enhancing such auditor skills include industry secondments and recruitment from a greater variety of disciplinary backgrounds, with such individuals subsequently incorporated into multi-disciplinary teams.
- Some interviewees envisage greater utilisation of IT capabilities as providing opportunities for enhancing assurance. Further enhancement of the revised audit reporting model was viewed as likely by some individuals.

9. CONCLUSIONS AND RECOMMENDATIONS

This chapter summarises the research conclusions under four headings. These are: FBU: interpretations; FBU: impact on corporate reporting; FBU: impact on audit and assurance; auditor skills and expertise. The relevant research question(s) are reproduced at the start of each section. Policy implications are then explored. The chapter concludes by suggesting areas for further research.

FBU: Interpretations

RQ 1 Is FBU considered to be an integrated concept or one of three discrete elements? How do individuals interpret the three elements within FBU?

The first research question explores how individuals interpret FBU conceptually. Individuals were asked whether they viewed FBU cohesively or as a looser conglomeration of three distinguishable elements and how they interpreted each element. There is no consistent view although most individuals view FBU as one concept, albeit differing on the extent to which its individual elements are distinguishable.

Individuals were asked for views as to how 'fair' and 'balanced' relate to one another. Some were clear as to how the terms differ. Some individuals, however, struggled to articulate a clear distinction. Of the two terms, 'balanced' is perceived as presenting the greater interpretative challenges and its inclusion is perceived to enhance corporate reporting.

'Understandable' is perceived to present the greatest challenge in terms of which sections of the annual report should receive most attention and in terms of to whom (i.e. which users) this relates.

There is little evidence of individuals representing a specific company or Big 4 firm exhibiting a common interpretive approach. In the case of auditors, this may be viewed as surprising.

Individuals appear comfortable with their personal interpretations and unchallenged in terms of meeting their FBU responsibilities. Absence of detailed regulatory definitions for FBU and the consequent scope for idiosyncratic interpretation,

however, may suggest a need for more detailed regulatory guidance.

ICAS (2010b, 2013, 2014a) has argued for a 'balanced and reasonable' 'front-half' opinion. However, following the introduction of FBU there is no evidence of strong support for this.

FBU: Corporate reporting

RQ 2 What is the impact of FBU and other related regulation on the 'front-half'?

RQ 3 What opinions have been received on FBU and 'front-half' assurance from investors?

The second research question investigates FBU's impact on corporate reporting especially the 'front-half'. FBU is perceived as beneficial. Generally, impact on content is perceived as modest; impact on the ordering and presentation of the 'front-half' and still more on 'in-house' process for considering style, tone and appropriateness, is viewed as significant. FBU is viewed as creating opportunities for a much more conscious and reflective process. There is generally a positive relationship between company size and formality and complexity of process. There is some suggestion that the modest impact on content reflects high quality reporting in the FTSE 100; it may be that investigating smaller listed companies would indicate more significant impact. Individuals are conscious of the need to assess content other than narrative, e.g. graphical, pictorial or photographic, for FBU, although the thoroughness with which this is done varies.

Despite the FRC's aim to cut clutter or make annual reports more clear and concise, FBU does not appear to have impacted significantly on the 'back-half'; if regulators wish to prioritise more accessible financial statements, more radical measures may be required. The incremental costs of FBU are regarded as very modest for the most part although there are one or two cases of significant additional time being spent on 'front-half' work. Around fifty per cent of non-auditors indicated additional time spent on preparation or review.

Little investor feedback, positive or negative, is apparent on FBU and on assurance thereon. It is unclear whether this reflects lack of interest, greater interest in initiatives such as revised audit reporting or belief that the complete annual report is already audited. Thus, there is need for further research on investor opinion.

FBU: Audit and assurance

RQ 4 What is the perceived scope of the assurance which auditors now provide on the 'front-half'?

RQ 5 How desirable and feasible would it be to upgrade the assurance provided on the 'front-half' to enable the provision of a positive opinion?

Existing audit reporting by exception on the 'front-half' is not perceived generally to have resulted in an assurance step change. A significant strand of opinion views the assurance provided as broadly similar to that applying under previous requirements for auditors to confirm that directors' and strategic reports are consistent with the financial statements and to identify inconsistencies between information disclosed in annual reports and that in the financial statements. A few preparers and audit committee representatives linked these views with auditors' unwillingness or inability to engage meaningfully with the 'front-half'. Some auditors, while unsurprisingly less critical about their own abilities, also view the 'new' requirements as having little incremental value.

Other opinion, however, does view FBU as resulting in significant enhancement of 'front-half' assurance. This view depends not on a belief that auditors are doing more assurance work *per se* but that that they now possess the necessary 'ammunition' with which to challenge boards meaningfully. A further enhancement of assurance is perceived to accrue from synergies resulting from interactions between FBU assurance and recent revisions to both audit reports and audit committee reporting.

Some auditors are now doing more work than previously on 'non-financial' 'front-half' numbers. No aspect of present FBU assurance is perceived as especially challenging to deal with and incremental assurance costs are generally regarded as insignificant. In most cases interviewees struggled to quantify these; if identifiable, in almost all cases additional audit costs were regarded as falling far short of five per cent.

There is no generally-held opinion in favour of providing positive assurance on the 'front-half'. This partially reflects perceptions that investors are not interested in positive assurance but an absence of robust empirical evidence leaves this untested. Auditors themselves, however, are optimistic on providing positive assurance. There is a suggestion that the dividing line between reporting positively

and by exception is less clear-cut than at first sight and some auditors view positive assurance as entirely possible, particularly if an agreed framework for this is in place.

There is general recognition that positive assurance on at least some 'front-half' content, such as historical KPIs, is technically feasible. However, there are significant reservations about opining positively on other 'front-half' material, for example, forward-looking content. Obstacles highlighted include potential litigation, conflation of auditor and management responsibilities and a lack of business understanding. Some view a positive opinion as to whether the annual report as a whole is FBU as inappropriate due to the subjective nature of much 'front-half' content. In contrast with reporting on FBU by exception, the potential costs associated with positive assurance are viewed as significant.

Auditor skills and expertise

RQ 6 How adequate are auditor skills in the context of FBU and other possible changes to assurance?

There is no general perception that auditors require familiarity with new skills to engage meaningfully with FBU. A business orientated mind-set and experience are regarded as the primary prerequisites and senior audit staff involved in FBU are generally considered to have these skills.

Nevertheless, a significant element of opinion believes that auditors exhibit insufficient business awareness more generally. This applies most obviously to junior auditors but some criticism of too much focus on technical accounting and compliance extends beyond junior auditors to partners.

There are a variety of opinions as to how assurance might develop in the future. There are two principal suggestions, not mutually exclusive; firstly, a greater emphasis on the 'front-half' and more commercially focused assurance and, secondly, development of real-time and other, technology facilitated, forms of assurance. Such proposals also suggest a possible need for corresponding changes to auditor training. An assurance focus on the 'front-half' may benefit from auditors with greater commercial focus or understanding; this might be facilitated by developments such as industry secondments appropriate to the individual's career stage. Real-time assurance suggests a possible need for the recruitment of more specialists from non-accounting backgrounds.

Further research

The findings of this project suggest a need for further research in several respects. Statutory and regulatory definitions relating to FBU are minimal. There is no detailed guidance as to how 'fair', 'balanced' and 'understandable' are to be interpreted although Stephen Hadrill, CEO of the FRC, has commented that 'fair, balanced and understandable' should be interpreted in accordance with standard dictionary meanings. Guidance on the issue of 'understandable to whom' is also lacking. There is therefore scope for research on how stakeholders interpret these and other similar terms. Given the view on the issue expressed by one auditor, research on the perceptions of auditors and others as to the technical difference between positive audit reporting and reporting by exception would also be an interesting exercise.

This research focuses on FTSE 100 companies (seven) with only two in the FTSE 250. It may be that the impact of FBU on the corporate reporting of the case companies, while beneficial, is less significant than it is on smaller, e.g. FTSE Smallcap, companies, where reporting may be of relatively poorer quality. Research focused on smaller companies may therefore be appropriate.

It is uncertain how FBU is regarded by investors and whether or not they view 'front-half' assurance as desirable and, if so, to what extent. Research to inform policy makers on the nature of demand for 'front-half' positive assurance would be appropriate. The nature of the positive assurance, if any, desired by investors requires exploration e.g. whether this applies to the 'front-half' as a whole or is restricted to only certain elements of it. Such research might also usefully explore how investors use the 'front-half' as well as their use of alternative information sources such as analyst briefings and 'real-time' information releases. Such research might also usefully investigate whether or not there is demand for external assurance on such information sources. It is also an open question as to how competent auditors are perceived to be by investors as potential providers of such assurance.

The research suggests concern as to auditors' commercial awareness. Auditors are viewed as too constrained in their thinking both by over-concentration on technical accounting and by a compliance-driven environment. Further research is therefore appropriate to consider the need for possible changes to auditor training and career development.

Policy implications

FBU is regarded generally as a 'good thing' and the benefits of the regulation are perceived to outweigh the costs. Thus there is no sense of any perceived need for radical revision of the FBU regulation. Given the generally favourable reaction to FBU within the UK, there may be scope for developing similar regulations within other national jurisdictions or for international regulators giving consideration to the possibility of developing similar initiatives.

There may be scope for further regulatory guidance on the interpretation of terms such as 'balanced' or 'understandable'. There are differing opinions as to whether or not the present assurance provision has incremental value compared with the assurance provided under the previous 'consistency' requirement. The FRC might usefully reflect on the extent to which the 2013 regulations concerning FBU were intended to enhance the value of the assurance provided on the 'front-half'.

In the light of perceptions that auditors, particularly those more junior, are insufficiently focused commercially, both regulators and professional bodies might consider whether or not the training, examination and experience requirements for individuals wishing to practice as registered auditors might benefit from revision and enhancement.

As noted in the previous section, issues concerning assurance on the 'front-half' remain to be explored with investors. The results of this further work may be useful to regulators and policy makers when considering further changes to 'front-half' assurance. Implementation of positive assurance would require agreement on a clear framework for such assurance as well as appraisal of the skills which would be required by the assurers. It would also be appropriate for policy makers to consider the apparent lack of interest by investors in the annual report as an information source and the consequent need to consider the role of alternatives, for example, information releases in 'real-time', including how, if at all, such sources should be regulated and whether or not there is scope for extending external assurance to them.

ENDNOTES

1. Throughout this report the term 'front-half' refers to those parts of the annual report which are presently unaudited; fundamentally the annual report other than the financial statements themselves.
2. As required by provision C.1.1 of the UK Corporate Governance Code (FRC, 2014a).
3. Premium listed companies are those which are required to comply with the highest UK standards of regulation and governance. Issuers with a premium listing are required to meet the UK's super-equivalent rules which are higher than the EU minimum requirements. A premium listing is a pre-requisite for inclusion in the FTSE UK series indices.
4. A positive opinion gives the highest level of assurance and is used when the auditor takes a definite position in respect of the assertion(s) which are the subject of audit or assurance. An obvious example is the audit opinion provided on the financial statements themselves; in this case, the auditor takes a definite position, which may be qualified, as to whether or not the financial statements give a true and fair view. A positive opinion may be contrasted with 'reporting by exception' where auditors typically only report where they have become aware of matters which are inconsistent with the assertion which is the subject of audit or assurance.
5. Lord Hoffmann and Dame Mary Arden in 1983 and 1984 and Dame Mary Arden in 1993.
6. The audit partner is referring here to the present assurance regulation in respect of the 'front-half'; strictly speaking the correct term for this, as noted elsewhere in this report, is 'reporting by exception' rather than 'negative reporting'; for the technical differences, see Hatherly (1997).

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Effective corporate reporting is essential to the efficiency of the capital markets but in recent years there have been significant concerns as to whether corporate reporting and the current levels of assurance are meeting the needs of investors. Various initiatives in corporate reporting have resulted in the 'front-half' of annual reports gaining greater prominence than has traditionally been the case – including the need for the annual report as a whole 'to tell the story'. However, it remains the case that it is only the conventional financial statements (the 'back-half' of the annual report) that currently receive a 'true and fair' audit opinion.

In order to address this apparent dichotomy, ICAS commenced a programme of work investigating the scope of assurance on the narrative elements of the annual report. This resulted in the publication in 2010 of research by Fraser et al. on users' views on external assurance and management commentary, and in 2011 of further research by Fraser and Pierpoint on auditors' views thereon. This research was used to inform the work of an ICAS working party, and culminated in a number of ICAS publications including *The Future of Assurance* and *Balanced and Reasonable*.

This new research is the next stage in that programme of work and was commissioned to investigate the impact of the fair, balanced and understandable (FBU) requirement – introduced by the UK FRC in 2012 into the UK Corporate Governance Code – on both corporate reporting and assurance and to consider whether it is feasible and desirable to upgrade the assurance provided on the 'front-half' from an exception-based to a positive opinion.

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