



University of Sheffield

Exploring the UK Extended Audit Report: Is bigger always better?

A field study of users' and auditors' experience

by

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A thesis submitted in partial fulfilment of the requirements for the degree of
Doctor of Philosophy

The University of Sheffield
Faculty of Social Sciences
Management School

8th of May 2023

Abstract

The UK was the first to implement the Extended Audit Report (EAR) as a technological intervention to repair and restore auditors' legitimacy after the numerous accounting scandals. The impact of audit work and the related audit failures affect everyone in the society directly and indirectly (CMA 2019). The academic research to date on the impact of the UK EAR involved archival and experimental studies with mixed findings (Smith 2023). Three research questions are addressed to obtain an in-depth understanding of the impact of the EAR. An interpretivist research approach using semi-structured interviews of users and auditors who use and prepare the EAR is used to explore these questions. First to determine whether the EAR succeeded in repairing auditors' legitimacy. Analysis of users' interview data applying Suchman's (1995) theory of organisational legitimacy showed the success of the EAR to restore legitimacy for auditors' actions but its failure to secure legitimacy for the essence of auditors. Second, to find out whether users trust the information in the EAR. Analysis of users' interview data using Sztompka (1999) social theory of trust showed that users do not trust the information in the EAR. The reasons behind this, stem from users lack of trust in auditors as the right social actor for the job in terms of their independence, accountability and competence. And finally, to capture the auditors' experience as preparers of the EAR and their reflections on the users' views. Analysis of auditors' interview data using the theoretical lens of the audit comfort framework (Commerford et al., 2016) shows that auditors use their comfort building strategies to create a state of comfort and move from the discomfort feeling associated with the risk of failing to detect material misstatements and arrive at the incorrect audit opinion in the EAR as the symbol of comfort. The findings of the research have theoretical, empirical and policy contributions that will be of interest to users, auditors, academics, regulators and audit policy makers.

Declaration

I, Mostafa Abuzeid, confirm that the Thesis is my own work. I am aware of the University's Guidance on the Use of Unfair Means (www.sheffield.ac.uk/ssid/unfair-means). This work has not been previously been presented for an award at this, or any other, university.

List of abbreviations

AICPA - American Institute of Certified Public Accountants

APB - Auditing Practices Board

AQR - Audit Quality Review

ARGA - Auditing, Reporting and Governance Authority

ASB - Auditing Standards Board

ASM - Audit Strategy Memorandum

CAPEX - Capital Expenditures

CAMs - Critical Audit Matters

CMA - Competition Market Authority

EAR - Extended Audit Report

EC - European Commission

FTSE - Financial Times Stock Exchange

FRC - Financial Reporting Council

IAASB - International Auditing and Assurance Standards Board

IFRS - International Financial Reporting Standards

ISA - International Standard on Auditing

ICAEW - Institute of Chartered Accountants in England and Wales

ICAS - Institute of Chartered Accountants of Scotland

KAMs - Key Audit Matters

LSE - London Stock of Exchange

M&A - Mergers and Acquisitions

NAS – Non-Audit Services

PCAOB - Public Company Accounting Oversight Board

PDD - Professional Practice Director

PIEs – Public Interest Entities

RMM - Risks of Material Misstatements

RNS - Regulatory News Service

RTA - Reflexive Thematic Analysis

SCOT - Significant Class Of Transactions

SEC - Securities and Exchange Commission

SRM - Summary Review Memorandum

Acknowledgements

First and foremost, I thank Almighty God for all his blessings and for giving me the strength, patience and perseverance to go through this long journey of learning and development.

I wish to thank my beloved long-suffering wife Menna for her continuous support through this long journey, I couldn't have done this without your support. I also thank my lovely children (Karma, Sam and Zain) for putting up with me working all the late hours and during holidays.

I wish to thank my fantastic first supervisor Professor Josephine Maltby, who passed away early on during my supervision journey, I greatly miss our discussions.

Many thanks to my supervisors Professor Sumon Bhaumik, Professor Jim Haslam, Professor Adam Leaver and Professor Stewart Smyth for their guidance, help, advice and support throughout this long journey. Particular thanks to Professor Stewart Smyth for guiding me through the last stages of my PhD journey.

I wish to thank all the anonymous interviewees who gave me their valuable time and insights.

Finally, thank you to all my colleagues at the Sheffield University Management School in particular the accounting and financial management division for their support and encouragement. Particular thanks to Professor Shuxing Yin my line manager for her continuous support navigating the HR complexities.

Dedication

This thesis is dedicated to my late father and my late mother who passed away during my PhD journey and were my biggest supporters, I miss them so much.

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Chapter 1: Introduction

1.1 Introduction

“The words the auditor dispenses are a powerful drug. They influence resource allocation in our society. Thus, the auditor's report represents a drug that should be dispensed and used with great care. Its purpose and limitations should be understood by users and they should be made aware of undesirable side effects and the dangers of misuse.”

Carmichael & Winters (1982, p.1)

Auditors' legitimacy have been contested in the aftermath of major corporate scandals (the likes of BHS, Carillion, Wirecard, Enron, Worldcom, Parmalat, Patisserie Valerie, Xerox, Lehman Brothers, Toshiba, TBW, Thomas Cook, FIFA, Tesco and most recently Silicon Valley bank, First Republic bank and signature bank to name a few) and the 2008 financial crisis (Sikka 2009, FT 2022a and FT 2023d). The failure of auditors in preventing such scandals, result in significant costs to the society, in terms of loss of jobs, pensions and lack of trust in the capital market (CMA 2019; Sikka 2009, 2021 and 2022). Using the analogy of Carmichael & Winters (1982), the auditor report represents the prescription drug which proved useless due to its generic steady use. The generic pass/fail binary audit report that looks the same whether it is a bank or an oil and gas company, led its users to lose confidence in the added value and credibility of the audit report and, hence limiting its usefulness. Auditors have been under a lot of criticism as they failed to detect or prevent the aforementioned fraud cases and are referred to as “watchdogs that don’t bark” (Coffee 2006). This has led to critics posing serious questions about auditors’ competence and independence, as they failed to deliver on their roles. Moreover, the lack of transparency on the quality of audits has significantly contributed to a reduction in public confidence. Consequently, this reduced confidence led to an increase in the audit

information gap component of the audit expectations gap. The gap represents the difference between users' expectations of the information they should get from an audit of the financial statements and the information they actually get from the audit report (Vanstraelen et al., 2012).

The audit expectations gap impairs auditors' legitimacy and as Sikka et al. (1998) contended it is unfavourable for both auditors and users. Auditors suffer from reduced public confidence in their work leading to lower reputational capital, credibility, earning potential and prestige associated with their profession. Also, for users the functioning of the capital market and wealth creation would be negatively affected by the loss of confidence in the auditor's role as monitoring mechanism essential in the process of accountability.

The audit report represents the only visible output of the audit process as other auditors' communications to the audit committee or management in its management letter are not visible to users (Manson and Zaman 2001). Hence the audit report is critical to users' assessment of the usefulness of the audit process. As a result, major standard setters and audit regulators such as the UK Financial Reporting Council (FRC), the US Public Company Accounting Oversight Board (PCAOB), the International Auditing and Assurance Standards Board (IAASB) and the European Commission (EC) have called for a revised and updated audit report, following public consultations and international academic research about users' assessment of the usefulness of the audit report. (EC 2011; FRC 2013; IAASB 2015 and PCAOB 2016)

The results of these outreach activities indicated that the traditional binary pass/fail one-page audit report or the slightly modified except for ones have little informational value. This short form audit report remained the same without any significant adjustment for more than 20 years where the last major change was in 1988 in the US and 1993 in the UK (Church et al. 2008). Moreover, virtually all companies receive a standard unqualified "clean" audit report¹, the

¹ For example, Lennox (2005) found that in a sample of 28,292 audit reports of SEC registrants from 1995 to 1998, 99.8% are standard unqualified audit reports (clean reports).

informational value of the short form report is reduced. Especially with hindsight virtually all the major corporate failures with accounting scandals (for e.g. Bear Stearns, Enron, Lehman Brothers, Northern Rock, Tesco, Worldcom, Silicon Valley Bank, First Republic Bank and Signature Bank) had been issued clean unqualified audit reports just before their collapse (Sikka 2009; FT 2023d).

The UK FRC was the first to implement the new Extended Audit Report (EAR) and introduced ISA 700 (UK and Ireland) (FRC 2013). The EAR represents a major change in the content of the audit reports as it opens the black box of the audit process and make it visible to the users of the audit report. Auditors of companies subject to the UK code of corporate governance from periods commencing on or after 1 October 2012 have to prepare the EAR, where the auditor reports on Key Audit Matters (KAMs) including the assessed risks of material misstatements that had the greatest impact on the audit, the materiality levels, and the scope of the audit given the materiality levels and the assessed risks of material misstatements. The intended benefits of this update are to increase: the confidence in auditing; the informativeness and value relevance of the audit report; the attention given by management and those charged with governance to the quality of disclosures to which reference is made in the auditor's report; and auditors' professional scepticism (Church et al. 2008; Mock et al. 2013; IAASB 2015; FRC 2015 and Bédard et al. 2016). However, after ten years of its introduction, multiple accounting scandals have casted several doubts about the achievement of these intended benefits were identified as highlighted in the next section.

Audit outputs are inherently difficult to measure, what constitutes a successful audit and high audit quality is difficult to measure and depends on the evaluator's socially constructed definition of success, or as Minutti-Meza (2021) describes auditing as having the attributes of a "credence good" making it difficult to assess its quality. Moreover, there is not enough visibility of the percentage of good quality audits versus bad quality audits. Audit quality

inspections conducted by the FRC provides a measure of the quality of audits of PIEs in the UK. The FRC selects a sample of the individual audits and report the findings to the audit firm and the audit committee of the auditees with one of four outcomes: good, limited improvements required, improvements required, and significant improvements required with the results of the last 5 years presented in the table below (FRC 2023).

Audit quality for the individual inspection				
Inspection cycle	Good or limited improvements required	Improvements required	Significant improvements required	Total
2022/23	104	26	12	142
2021/22	104	30	14	148
2020/21	99	41	7	147
2019/20	81	34	15	130
2018/19	96	33	7	136

Source: FRC (2023)

Media attention is only focused on the accounting scandals in which auditors were found to be negligent and at fault for example in the UK, Tesco, Carillion, Patisserie Valiere and Thomas Cook. These scandals casted a big doubt on the EAR effectiveness and whether it is just a compliance exercise.

Unfortunately for the auditor and the EAR, all these companies received clean unqualified opinion audit reports by their auditors before the scandal was discovered. In hindsight it looked even worse as the EAR contained the risks that led to the scandals in the KAMs and auditors were satisfied with the measures taken by the auditees to address these risks. For example, in 2014 the first KAM in Tesco's EAR were fraud in commercial income which materialised a

couple of months later as £250m fraud in commercial income related to suppliers' rebates. Similarly, recognition of contract revenue for Carillion 2016 EAR was included in the KAMs and one year later Carillion collapsed and one of the main reasons was fraud in the recognition of contract revenue (Minutti-Meza 2021).

One could argue that in total this is a small percentage compared to the total number of audits. But then the question what is an acceptable percentage of low-quality audits? Or what about accounting fraud that is still undetected or significant improvements needed in the audit reports not included in the FRC audit inspection samples.

Furthermore, a recent report published in May 2024 by the audit reform lab (2024) which provided valuable insights to quantify the audit failure in the UK. The report analysed 250 audit reports from 2010 to 2022 of UK listed companies that collapsed during this period and found that auditors failed to give going concern warnings in 3 out of 4 audit reports. This report defines audit failure based on the failure of the auditors to report a material uncertainty about the company ability to continue as a going concern in the audit report in the year prior to the collapse of the auditee.

The rest of the chapter is organised as follows: section 1.2 presents the research motivation and the research questions. Section 1.3 highlights the research contributions. And section 1.4 presents the thesis overview.

1.2 Research Motivation and Research Questions:

Auditors' work has a significant impact directly and indirectly on everyone in the society. It affects the savings, pensions, jobs and the livelihood of the members of any society. Both for those who read and use the audit reports and those who do not (CMA 2019). Hence, after the extension of the audit report it is crucial to assess its impact as the only visible output of the audit process. The research to date on the UK extended audit report involved archival studies

with mixed findings focusing on the capital market impact of the report (Bédard et al. 2016; Smith 2023 and Velte and Issa 2019). These findings suggest a need for an in-depth study to complement this literature and to contribute to a richer understanding of the effectiveness of the EAR. A major limitation of these studies is their inability to separate the audit report from the annual report as both are published at the same time and as Bailey (1982) contends users are concerned with the aggregate signal in the company's account. This aggregate signal consists of the narrative disclosures (the front end of the annual report), the audit report, financial statements and notes disclosures. Any change in share prices or cost of capital can be related to any of these components not specifically to the audit report (Ball et al. 2012). Similarly, Leuz and Wysocki (2016) contend it is challenging and difficult to get credible evidence about the economic consequences for the studies of disclosure regulation due to the difficulty in separating the disclosure impact from the underlying economics. Moreover, the studies that found the extended audit report uninformative for e.g. Gutierrez et al. (2018) do not specify why it is uninformative and does not contain new information. Various possible explanations that I have listed below might be the reason. The archival studies only rely on proxies for the objective rational economic decision maker to test the informational content without having an understanding of the users' and auditors' experiences in a complex expert practice like auditing. This is a limitation of the archival research that cannot simply control for these competing explanations as control variables in a regression. Furthermore, academic research on other audit reporting initiatives relies on experimental studies that use hypothetical scenarios with relatively unsophisticated users. The drawback of these studies is that they lack the real-life experience of an actual EAR user using the EAR of an actual listed company. Moreover, using MBA students in a classroom experiment setting while providing useful insights, does not provide the in-depth insights provided by the actual users of the audit report (Bédard et al. 2016; and Velte and Issa 2019).

Conceptually there are various competing explanations that make it hard to tell whether the new EAR will be effective. As on the one hand, the extended audit report could be effective, since auditors now are disclosing more information about the audit process and the risks of material misstatements. This would lead to a reduction in the information asymmetry and information risk giving users more confidence and assurance on the quality of the financial statements information as well as the monitoring function performed by the auditor as one of the solutions to the agency problem. And as a result, users can rely on the financial statements information of the audited company to make an informed decision.

And on the other hand, the new report can be ineffective due to several possible explanations. First, according to Institutional theory, coercive isomorphism (DiMaggio and Powell 1983) might be the response of auditors as a result of the new audit reporting standard mandated by the FRC to gain legitimacy, regain public confidence and maintain their reputational capital. This might lead to a “Label Adoption” where auditors just conform to the letter of standard rather than its spirit, resulting in symbolic boilerplate auditor disclosures. As Power (1999, page 31) contends:

“This is the great institutional strength of financial auditing and the idea of audit which it promotes. Auditing responds to pressures for reform in a manner which constitutes a legitimate response but at the same time also preserves its essential obscurity, an obscurity which is overcome by trust in auditor judgement. As a result, the success or failure of auditing is never a public fact but is always an object of persistent dispute, an adversarial process in which questions of blame are at stake.”

This could be explained by the process of “decoupling” where the formal structure does not conform to the actual practice, which produces cosmetic external legitimacy with the wider

stakeholders resulting in uninformative reports without real usefulness or legitimating impact (Meyer and Rowan 1977; Power 2003 and Baker et al. 2014).

Second, the increased ex-ante disclosures by the auditor might increase auditors' exposure to litigation (Backof et al. 2022). Thus, the auditors would be reluctant to provide granular risk disclosures and instead provide generic disclosures of low informational content. Conversely, Brasel et al. (2016) found that the auditor disclosures offer litigation protection for auditors, therefore there are legal motives to increase the quantity of these disclosures with generic standardized boilerplate disclosures, hence diluting the informativeness of the relevant disclosures. Either way the risk of litigation might limit the informativeness of the extended audit report.

Third, according to Watts and Zimmerman (1986), auditor monitoring would only be valuable if there is a non-zero probability that the auditor will report a contract breach. Thus, the auditor needs to be competent to be able to discover breaches in contracts by management, and at the same time be independent from management to report it. And since auditors also act as an agent to the shareholders, who delegate the process of hiring and paying for the auditor to the managers who the auditor should report on their performance, serious questions arise about the auditor independence and whether they should be trusted. These independence concerns make it difficult to predict whether auditors are willing to qualify their audit opinion in case of a high risk of material misstatement without the appropriate mitigating controls by the auditee and disclose it in the audit report. Hence there is a risk that auditors might want to please the auditee management by not disclosing these risks in their audit report, in order to get some of the more lucrative non-audit consultancy business. Thus, auditors are subject to different and in sometimes clashing incentives especially in the case of negative risk disclosures about the client, to please the client who pays their fees and to avoid litigation, regulatory sanctions and reputational damage. Or in other words, as Coffee (2006) describes it as "reputational

schizophrenia” trying to have both a reputation of being flexible and supportive for their auditees and tough and strict for users. As a result, boilerplate disclosures might be the solution.

Fourth, not only the auditor’s organizational independence but also auditor’s operational independence (Power 1999) might have an impact. As the auditor needs to establish good relations with the auditee to increase their willingness to cooperate with the auditor to collect sufficient audit evidence i.e. to detect the risks of material misstatements. This can reduce the willingness of auditors to displease the auditee (Guenin-Paracini 2015). Also, the increased auditor disclosures might have unintended consequences based on “Moral License Theory” as auditors have already given a warning to users about the risks of material misstatements which might lead to less scepticism by auditors regarding the reliability of the estimates included in the accounts (Griffin 2014).

Fifth, the market for audit firms is basically an oligopoly where the big 4 audit firms control the market and might collude together and produce standardized generic uninformative boilerplate risk disclosures. This will result in “Mimetic Isomorphism” (DiMaggio and Powell 1983). By doing so, auditors will reduce their litigation risks and please their auditees (Coffee 2006; Lennox et al. 2022).

Eventually, in theory auditors act as a repeat player who have the competence and expertise from auditing various clients, have a reputational capital that they need to maintain, so ideally they have an incentive to avoid the risk of decline in this reputational capital by providing informative audit reports that signal the quality of their work, since the loss of reputation of the audit firm as a whole far exceeds the gains from any single audit client (Coffee 2006).

Audit firms contain staff at different levels of experience starting from associates, seniors, managers, senior managers and partners who have their name on the audit report and are responsible for the audit. Audit partners are subject to higher incentives as big part of their

compensation comes from profit share in addition to their salary. Moreover, to reach and maintain partner level they need to bring and maintain clients to their audit firm. However, agency problems might exist within the audit firm (the principal), where auditors of one office (agents) might want to acquiesce with the client to generate private benefits or reach individual fees targets. This risk of “agent capture” by the auditee depends on the quality control measures and the degree of monitoring within the audit firm regarding their individual audit partners and how often the audit firm rotates its audit engagement partners (Coffee 2006).

Consequently, there is a need to obtain insights from both the users and the preparers of the EAR in order to have an in-depth understanding of the effectiveness of the EAR to repair auditors’ legitimacy and increase its informativeness and credibility.

The term “users” is very broad and involves a big diverse group of stakeholders. These stakeholders include equity investors, creditors, employees, trade unions, governments, regulators, the public, business contract group like customers, suppliers and competitors (ICAEW 1975). Each user group will have different information needs that might not necessarily be similar to the other user groups. For example, equity investors put more focus on share price related financial information to help make their investing decisions while governments will focus more on taxes and compliance with laws and regulations. Given the limitation on the number of interviews that can be conducted and the challenges to access the different user groups, I followed the conceptual framework of financial reporting (IASB) in focusing on the primary users as current and potential investors (or shareholders) who invest in UK listed companies that are subject to the EAR standard and in this study the term users will refer to the equity investor user group. I acknowledge, this selection as one of the research limitations as discussed in Chapter 8 and it provides an opportunity for future research to capture the views of the other equally important users of the EAR. As Young (2006, p. 581), warns that the standard setters’ definition of users as rational economic agents risks replacing

“flesh and blood users” with “hypothetical users”. This focus on decision usefulness crowds out the moral accountability of businesses where poor working conditions can be justified based on cost reductions.

Hence, I used semi-structured interviews as the research method to capture the experiences of the users to address the first research question:

RQ1: Did the EAR succeed in repairing Auditor’s legitimacy?

The reflexive thematic analysis (Braun and Clarke 2022) of the users’ interview data helped me to address the first research question using the theoretical lens of Suchman’s (1995) theory of organisational legitimacy. The introduction of the EAR as a new technology to restore legitimacy for auditors succeeded in restoring legitimacy to the actions of auditors but failed to secure legitimacy to the essence of auditors or in other words the legitimacy of auditors themselves. Users appreciate the new information about KAM’s, materiality levels as doing the right thing. It helped to secure pragmatic (exchange), moral (procedural) and cognitive (understandability) legitimacy.

However, The EAR failed to achieve the pragmatic (dispositional), moral (structural and personal) and cognitive (taken for grantedness) legitimacy as users do not see auditors as the right social actor for the job. This led the researcher to come up with the second research question:

RQ2: Do users trust the information in the EAR?

The reflexive thematic analysis of users’ interview data using the theoretical lens of Sztompka (1999) social theory of trust showed that users do not trust the information in the EAR. The reasons behind this, stem from users lack of trust in auditors. As users do not trust the primary sources of trust in the appearance, present and past performance of auditors. Additionally, they do not trust secondary sources of trust in the accountability of auditors in the current regulatory

setting. Particularly users do not trust the independence, accountability and competence of auditors and the audit process.

This helped the researcher to unpack the usefulness and the impact of EAR on auditors' organisational legitimacy and whether users trust the information in the EAR. Furthermore, it enriches our theoretical and empirical understanding of the impact of the EAR against the backdrop of the mixed theories and the mixed findings of the archival and experimental studies explained in detail in chapter 3 the literature review and chapter 4 the theoretical framework.

A total of 16 semi-structured interviews (detailed in chapter 5 table 5.1) ranging from 35 to 70 minutes with users were conducted online via video-conferencing services zoom and google meet and face to face to address the first and second research questions.

Eventually, to get a holistic understanding of the impact of the EAR, auditors' side of the story as preparers of the EAR need to be analysed. Up to the researcher knowledge, after the introduction of the EAR, no academic research focused on the auditors' experience in applying the new report. Knowing the auditors' side of the story allowed a more in-depth understanding of the impact of the EAR and provided an opportunity for auditors to reflect on the concerns raised by the users. Furthermore, it informs the regulators about the effectiveness of the new audit reporting model. This led to my third research question:

RQ3: What is the auditors' experience of implementing the EAR? What are their reflections on the concerns raised by users?

Therefore, by talking to auditors who prepare the EAR it allowed the researcher to examine the "organisational reality" of the process of generating the EAR (Power 1995) using the audit comfort framework (Pentland (1993); Carrington and Catusus (2007); and Commerford et al., (2016)) as the theoretical lens. A total of 15 interviews (detailed in chapter 5 table 5.2) ranging from 35 to 70 minutes with auditors were conducted online via video-conferencing services

zoom and google meet to address the third research question. The researcher analysed the usage of EAR as an audit ritual to produce comfort (Pentland 1993; Power 1999). Auditors also reflected on the concerns on their independence, accountability and competence raised by the users. The results show a need for a more nuanced analysis of the views of auditors and users to restore trust in auditing and reduce the information performance gap component of the audit expectations gap. As consolidating the views of users and auditors show that bridging the information gap is not just about providing more information, as users need to first trust the information included in the EAR. And for this to be done, they need to trust the source of this information which is the auditors who prepare the EAR.

1.3 Summary of Research Contributions

The research's original contribution to the existing body of knowledge is threefold, empirical, theoretical and policy contributions.

1.3.1 Empirical Contributions

The research to date on the effectiveness of the EAR in the UK and globally is predominantly archival or experimental in nature with mixed findings and many limitations (Bédard et al. 2016; Velte and Issa 2019 and Smith 2023). Hence doing a qualitative field study helps obtain an in-depth understanding of how users perceive the EAR and represents an investment in “knowledge diversification” and “methodological pluralism” which is quite important in a complex process like auditing (Humphrey 2008; Power and Gendron 2015).

The study results point to a descriptive view of the effects of the EAR from the interviewed users' perspectives to complement the empirical difference-in-difference approach focusing on the economic effects of the EAR.

Finally, after the introduction of the EAR, to the best of the researcher knowledge, no published academic research to date focused on the auditors' experience in applying the new report. Interviewing auditors who prepare the EAR allowed me to examine the “organisational reality” of the process of generating the EAR (Power 1995). This resulted in an in-depth analysis which expands our understanding of how the EAR is prepared by the auditors. For example, the trade-offs auditors face in determining what to include in the EAR from the audit file to make it informative but at the same time avoid overloading the users with too much information.

This research extends the knowledge and scholarship of the organisational and social context of accounting and auditing research in action, by engaging directly with practitioners. Otherwise, the study of accounting and auditing will exist in as described by Hopwood (1979,

page 147): “*a void, within a world grounded in the myths of the accounting mission rather than the achievements of accounting in practice.*” (Hopwood 1979; Power and Gendron 2015).

1.3.2 Theoretical Contributions

The thesis contributes to the study of auditing as a social practice rather than just a technical practice (Flint 1988). It provides evidence of the shortcoming of the widely used agency theory framework in explaining the failure of EAR to restore trust in auditing. This was done by using Suchman’s (1995) theory of organisational legitimacy and its analytical types to analyse how the EAR achieved legitimacy for auditors’ actions (pragmatic exchange legitimacy, procedural moral legitimacy and cognitive understandability legitimacy) and its failure to achieve legitimacy for auditors’ essence (dispositional pragmatic legitimacy, structural and personal moral legitimacy and cognitive taken for granted legitimacy).

Furthermore, it extends the literature on the use of Sztompka (1999) social theory of trust in auditing research and its sources to explain why users do not trust the information in the EAR.

Moreover, the thesis extends the usage of the audit comfort framework (Pentland (1993); Carrington and Catusus (2007); and Commerford et al., (2016)) in auditing research, addressing the relative scarcity identified in the literature of in-depth research with direct engagements with auditors to gain their perspective (Gendron & Spira 2010; Humphrey 2008; Power 2003 and O’Dwyer et al. 2011).

Finally, whilst the research did not address the audit expectations gap directly in the research questions, it made a contribution to the expectations gap literature. Despite the success of the EAR in providing more information to users, it appears to have failed to reduce the information gap component of the audit performance expectations gap as users do not trust this information. This highlights that the performance information gap is not just about the information expected by users, it is more about whether users trust the auditors themselves to be able to trust the

information they provide in the EAR. Interviewed auditors were confident and comfortable about their independence, competence and accountability, however this comfort is not transferred to users. A clear perception gap exists and by synthesising the views of the users and auditors in terms of the reasons behind the users' lack of trust in the information in the EAR in particular and the audit profession in general it offered users and auditors' suggestions for improvements to bridge this gap. This is particularly important, as audit expectations gap impairs auditors' legitimacy and as Sikka et al. (1998) contended it is unfavourable for both auditors and users. Auditors suffer from reduced public confidence in their work leading to lower reputational capital, credibility, earning potential and prestige associated with their profession. Also, for users the functioning of the capital market and wealth creation would be negatively affected by the loss of confidence in the auditor's role as monitoring mechanism essential in the process of accountability.

1.3.3 Policy contributions

The findings of this research provide useful insights for the regulators and audit policy makers in the UK, about the effectiveness of the EAR and whether it succeeded in repairing auditors' legitimacy? And the reasons behind its failure to do so. It highlights the strengths of the EAR and provide users' and auditors' suggestions for improving its shortcomings. And as explained in section 8.4 the recommendations of the thesis go beyond the EAR to include structural changes to the audit industry to restore its legitimacy and improve its effectiveness. Furthermore, because of the similarity between the UK extended audit report and the IAASB standard ISA 701 which require the disclosure of KAM's, the findings would be useful to other countries applying the IAASB new standard (IAASB 2015). Additionally, it would add insights to the US version of the extended audit report, where Critical Audit Matters (CAMs) required by the PCAOB AS 3101 standard for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after Dec. 15, 2020 for all other

companies (PCAOB 2016), which represents the US version of KAMs or risks of material misstatements found in the UK report.

1.4 Thesis structure:

The thesis is structured as follows: Chapter 2 provides the background of the auditing function and its purpose along with the historical development of different versions of the audit reports till the issuance of the EAR. It also gives background on the audit expectations gap. Chapter 3 provides a review of the relevant literature. Chapter 4 provides the theoretical framework used in the research. Chapter 5 provides a description of the research methodology including the ontological and epistemological assumptions, research design, research methods and data analysis. Chapter 6 provides the analysis of the findings of users' interviews. Chapter 7 provides the analysis of the findings of auditors' interviews. Chapter 8 provides the Discussion of Findings, Conclusions and Recommendations, Research Contributions, Limitations, and Areas for further Research.

Chapter 2: Background

2.1 Introduction:

This chapter provides the context and background of auditing and audit reports. Section 2.2 presents the definition and role of external auditors. Section 2.3 presents the historical developments of the audit reports in the UK. Section 2.4 discusses the audit expectations gap. Section 2.5 provides a summary.

2.2 The objective of financial statements audit and the role of external auditor:

The purpose of financial statements audits according to ISA 200 UK (FRC 2016, p. 4) is:

“To enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general-purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with ISAs (UK) and relevant ethical requirements enables the auditor to form that opinion.”

In the context of financial statements audit in the UK, the external auditor collects and assess audit evidence to form an opinion on whether the financial statements “the information” of the auditee represents a true and fair view in accordance with the International Financial Reporting Standards (IFRS) “the established criteria”. As according to Arens et al. (2017, p. 28) textbook definition of Auditing:

“Auditing is the accumulation and evaluation of audit evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by competent, independent person.”

The external auditors are licenced by professional bodies like the Institute of Chartered Accountants in England and Wales (ICAEW), the Institute of Chartered Accountants of Scotland (ICAS) and the American Institute of Certified Public Accountants (AICPA) after sitting for exams and satisfying the education requirements in order to ensure their competency. And to aid the independence of external auditors the hiring of external auditors is done by the audit committee members of the board of directors which is formed of independent non-executive members. However as mentioned earlier in the research gaps the independence of auditor in reality is more complicated and contentious (Tepalagul and Lin 2015; Mautz and Sharaf 1961; Flint 1988; and Gray et al. 2019). When conducting the audit of financial statements auditors typically follow the International Standards on Auditing (ISA).

The primary users of the audited financial statements according to the conceptual framework for financial reporting (2018) are current and potential investors, lenders and other creditors. Other stakeholders also use the audited financial statements like trade unions, environmental protection agencies, tax authorities, regulatory bodies (IASB 2018). However the focus in this research is on the primary users. This selection is one of the research limitations discussed in Chapter 8 and provide an opportunity for future research to capture the views of the other equally important users of the EAR. As Young (2006, p. 581), warns that the standard setters definition of users as rational economic agents risks replacing “flesh and blood users” with “hypothetical users”.

Brydon (2019, p.22) in his review recommends the purpose of an audit to be incorporated by the government in the company’s act as:

“To help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements.”

Auditors serve as a gatekeeper in the context of corporate governance by acting as a “reputational intermediary” to give assurance to the users of the financial statements about their quality through an unqualified or clean audit report (Coffee 2006).

However, to achieve all the above objectives, auditors themselves need to be trusted to be able to transfer this confidence and comfort to the users of the audit work. Therefore, the role of auditing as a social process needs to be carefully examined, as Flint (1988, p.14) defines auditing more broadly as a social phenomenon, which serve as a social control mechanism to achieve accountability:

“Audit is a social phenomenon. It has no purpose or value except in its practical usefulness. It is wholly utilitarian. The function has evolved in response to a perceived need of individuals or groups in society who seek information or reassurance about the conduct or performance of others in which they have an acknowledged and legitimate interest: it exists because the interested individuals or groups are unable for one or more reasons to obtain for themselves the information or reassurance they require. The social concept of audit is a special kind of examination by a person other than the parties involved which compares performance with expectation and reports the result: it is part of the public and private control mechanism of monitoring and securing accountability.”

Without an in-depth understanding of the societal needs and expectations, auditors would fail to achieve their objectives in a way that satisfy societal needs. This is what is referred to in the literature as the audit expectations gap which is discussed in section 2.4.

The audit report plays such an important role in establishing legitimacy in auditors’ work, as it represents the only visible output of the audit process (CMA 2019). Auditors’ work is more comprehensive, but it is not visible or available to general users. For example, auditors document all their work and evidence in their audit file. They also prepare a report to the audit

committee and management letter points which is only available internally for their audit clients. Hence, the audit report is crucial in establishing legitimacy for auditors' work as a symbol of comfort (Power 1999). There are four main types of audit reports (Gray et al. 2019). The first type is the unqualified (unmodified) opinion audit report which is a clean report meaning that the financial statements are true and fair. The second type is the qualified audit report "except for" which can be qualified either due to scope restriction and/or opinion due to departure from the applicable accounting framework IFRS. The third type is the adverse opinion when the financial statements are materially misstated and do not present a true and fair view. The last type is the disclaimer of opinion audit reports when the auditor is not independent from the auditee or suffers from a severe scope limitation. The standard unqualified (unmodified) report has a variation which is the unqualified opinion with emphasis of a matter (also called an explanatory paragraph in the US) where the auditors draw the attention to a specific issue like going concern without qualifying their opinion (Arens et al. 2017; Gray et al. 2019).

The focus of this research is on the standard unqualified audit report, which is the most common type of audit reports and as mentioned in the introduction, the one that is suffering from the lowest informational content due to its standardised binary pass/fail nature and is expected to benefit the most from the updated extended reporting standard. The next section will track the historical development of the UK standard unqualified audit report to highlight the difference between the short form and extended audit reports.

2.3 The development of the Audit Report in the UK:

The UK was historically one of the leading countries to deal with auditing and audit reports due to the industrial revolution which began in Britain as a big colonial power, shifting from agrarian activities into industrial activities that eventually led to the formation of big enterprises and corporations (Napier 2010). Due to the separation of ownership and control in these entities

the need for monitoring and reporting became essential. The UK's Joint Stock Companies Act of 1844 introduced the requirements of keeping proper accounting records and the appointment of auditors to produce and register an audited balance sheet. However, these requirements were repealed later by the Joint Stock Companies Act 1856 that made it optional for these companies. While not mandatory references to the audit report can be found in the UK Companies Act of 1862 which suggested that the accounts of the company should be examined at least once in every year and the auditors should make a report about whether the balance sheet is full and fair. Afterwards, the UK Companies Act of 1900 reinstated the requirements of keeping proper accounting records and the appointment of auditors to produce and register an audited balance sheet, which had to be annually presented to the shareholders (Maltby 1998 and Napier 2010). Then, the UK Companies Act of 1947 introduced the requirement for auditors to report on every profit and loss account to determine that it gives a true and fair view. Moreover, this act introduced the requirement for the auditor to have a professional accounting qualification. The UK Companies Act of 1948 required the auditors to state in the Auditor's report whether they have obtained all the information necessary for the purposes of their audit. In 1980 the first UK standard on audit reporting was issued by the Auditing Practices Committee (APC)²

Afterwards, the UK Companies Act of 1985 stated that the auditors have a duty to consider whether the information in the directors' report is consistent with the audited accounts; and if not, they should include this fact in the audit report.

The UK Companies Act of 1989 required the inclusion of the auditor's name and signature in the audit report. In 1993 the UK Auditing Practices Board (APB) issued an expanded audit report standard SAS 600³ that attempts to educate users about the audit process by including in

² A sample of the audit report format suggested by the standard is provided in appendix 2.

³ A sample of the audit report format suggested by the standard is provided in appendix 2.

the scope paragraph the management and auditor's responsibilities which was similar to the US Auditing Standards Board (ASB) Statement on Auditing Standards No. 58. The purpose of this standard was to reduce the reasonableness component of the expectations gap as users of the audit report needed more information about the scope and nature of auditing (Manson and Zaman 2001; FRC 2007). The UK Companies Act of 2006 required the auditor to give a three-part opinion on whether the accounts give a true and fair view, have been prepared in conformity with the relevant accounting standards, and have been prepared in accordance with the Companies Act of 2006 (FRC 2007).

Eventually, after an extensive outreach activities conducted by the UK FRC in 2012, it introduced ISA 700 (UK and Ireland) for companies subject to the UK code of corporate governance from periods commencing on or after 1 October 2012 to prepare the extended Audit report⁴, where the auditor reports on key audit matters including the assessed risks of material misstatements that had the greatest impact on the audit, the materiality levels, and the scope of the audit given the materiality levels and the assessed risks of material misstatements (FRC 2013). The intended benefits of this update are to increase: the confidence in auditing; the informativeness and value relevance of the audit report; the attention given by management and those charged with governance to the quality of disclosures to which reference is made in the auditor's report; and auditors' professional scepticism (Church et al. 2008; Mock et al. 2013; IAASB 2015; FRC 2015 and Bédard et al. 2016).

The FRC (2013a) received 31 responses to its consultation on the revision to the EAR standard ISA 700 (UK and Ireland). The majority of responses, on balance supported the proposal with the detailed breakdown provided in the table below:

⁴ A sample of the audit report format suggested by the standard is provided in appendix 2.

Formal responses to the Consultation

3.1 31 responses to the Consultation were received from the following stakeholder groups:

• Investors	11
• Audit Firms	11
• Accounting Institutes	4
• Preparers of financial statements	1
• Public Sector	1
• Other organisations	<u>3</u>
	<u>31</u>

A list of the respondents is set out in the Appendix.

3.2 There is a wide diversity of responses which we have categorised as follows:

• Agree with proposals	9
• Agree with thrust of proposals but suggest improvements	10
• Agree that the proposed disclosures should be made but by the audit committee rather than in the audit report	2
• Broadly agree with the proposal but do not support the FRC moving in advance of the IAASB	5
• Disagree with proposals	<u>5</u>
	<u>31</u>

Source: FRC (2013a)

Other than a disagreement of 5 stakeholder with the timing of implementing the proposal before the IAASB not the proposed changes itself, 5 stakeholders disagreed with the proposal. These stakeholders consist of 3 non big 4 audit firms, an academic and the Irish accounting institute. The audit firms argued that there is a significant increase in their audit risk, and it would not help in promoting competition in the audit market with bigger auditors. The Irish accounting institute wanted more guidance and examples to auditors before implementing the change to the audit reporting standard. The academic commentator did not support that the changes to the audit report will help the investors with their information needs (FRC 2013a). Conversely, Wilson (2021, p. 582) as a member of the codes and standards committee explains that the main reason behind the genesis of the EAR in the UK is the investors' needs to have a "lens into the discussion between the auditor and the audit committee".

Simnett and Huggins (2014), analysed 165 stakeholders' responses and to the IAASB's 2012 invitation to comment on the suggested improvement to the audit. They classified the respondents into audit firms, investors and analysts, professional accounting bodies, regulators and standard setters, public sector organisations, academics and individuals. They also classified the responses based on then geographic location of the respondents into North America, South America, Europe, Asia, Oceania, Africa and international companies. They found that 74.4% of the respondents agreed to the changes and those who disagreed tend to be the north American audit firms and professional accounting bodies citing increased litigation risk as the main reason of opposing the changes proposed by the IAASB.

So, to sum up, the short form binary audit report was either black or white. Formed of three paragraphs an introductory paragraph listing the audited financial statements, a scope paragraph describing what an audit is and what are the respective responsibilities of management and auditors and an opinion paragraph whether pass or fail without any information about how the auditor arrived at this opinion. However, the extended audit report provides more shades of grey in terms of increased granularity regarding each company key audit matters and materiality levels and how the scope of the audit was tailored to address these issues.

In the next section, I discuss the audit expectations gap, highlighting the information gap which is addressed indirectly by answering the three research questions.

2.4 Expectations Gap in Auditing:

Audit failures have always been the cause of a big public debate about the role of auditors and their effectiveness. It started as early as 1878 with the failure of the incorporated city of Glasgow bank, where the management overstated assets and understated liabilities to hide the bank's insolvency (Humphrey et al. 1992). The first formal reference to Audit Expectations Gap was made in the US Commission on Auditors' Responsibilities known as the Cohen Commission (1978). They found, inter alia, a gap between public expectations about auditing and what audit can reasonably achieve and voiced concerns about the effectiveness of the short form standard audit report as a communication device.

IAASB (2011, page 7) defined the audit expectations gap as:

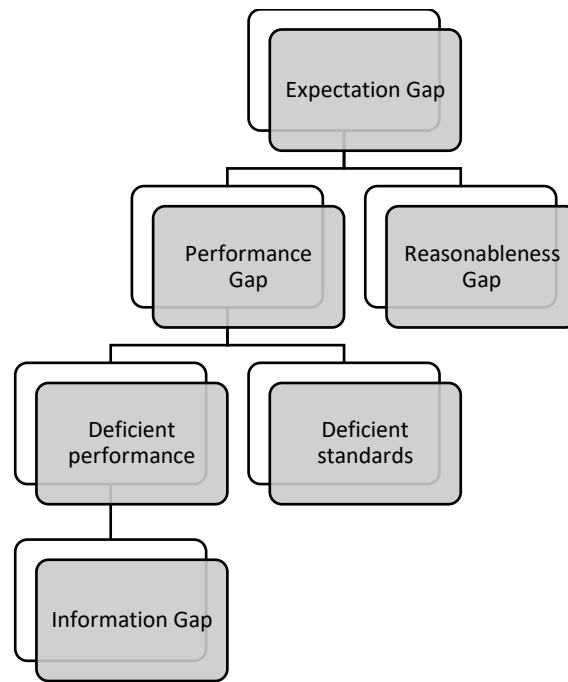
“The difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is.”

According to Porter (1993), audit expectations gap can be expressed in terms of an “*audit expectation-performance gap*” which is the difference between public expectations from auditors and the auditors' performance perceived by the public. And this gap can be divided into reasonableness gap and performance gap (Porter 1993; Gray et al. 2019 and Coram and Wang 2021). The reasonableness gap is the difference between the public expectations from auditors and duties that are reasonably expected from auditor in terms of costs relative to benefits. For example, some users expect that the audit should give absolute assurance that the financial statements are free from fraud. This expectation is unreasonable due to the inherent limitations of the audit process and the intention to deceive associated with fraud, which if combined with collusion would make it impossible for the auditor to detect fraud (McEnroe and Martens 2001). Another unreasonable expectation is that auditors should audit 100% of the financial statements balances which is not cost beneficial for auditors, as this would result

in huge costs for auditors exceeding their audit fees from a given client (Porter 2012). This is why auditors use sampling and give reasonable not absolute assurance on the material balances.

The performance gap is the difference between duties that are reasonably expected from auditor which are cost beneficial for the auditors and public perception of auditor's actual performance.

The performance gap can also be subdivided into deficient standards and deficient performance gaps. The "deficient standards" gap is the difference between auditor duties under current standards and regulations and duties that are reasonably expected from auditor. For example, the expectation that the auditor should provide positive assurance about social and environmental disclosures in the front end of the annual report are reasonable expectations that are cost beneficial to the auditors, however they are not required by the existing regulations and auditing standards as auditors only say that the information is consistent with the financial statements. The "deficient performance" gap is the difference between auditor duties under current standards and what public perception of auditor's actual performance. Related to this gap is the information gap which is the difference between the information needed by users from the audit report and the information that is available through the current audit report (Porter 1993).



Source: Porter (1993)

Several academic studies using survey questionnaires sent to users and auditors, documented the existence and persistence of the audit expectations gap in the UK and internationally (For e.g. Humphrey et al. 1992; Porter 1993; McEnroe and Martens 2001; Lin and Chen 2004; Dixon et al. 2006; Porter et al. 2012 and Ruhnke and Schmidt 2014).

According to Humphrey et al. (1992) the audit profession responses to the expectations gap can be categorized into two approaches: a defensive approach and a constructive approach. The defensive approach focuses on educating the public about the role and responsibilities of auditor to remove all the misconceptions and unreasonable expectations. Thus, blaming the users and confining the audit expectations gap to a reasonableness gap. Under this approach there is no need to improve the audit report or increase the auditor responsibilities as the problem rest with users and their unreasonable expectations. The constructive approach focuses on increasing the scope of the auditor responsibilities and meeting the expectations that are reasonably expected from the auditors. Earlier UK studies discussed in chapter 3 covering the impact of changes in audit reports wording on the audit expectations gap, have found the

changes giving more generic information about auditing rather than the results of the particular audit engagement (For e.g. Hatherly et al 1991, Innes et al. 1997 and Manson and Zaman 2001).

This research will focus on the information gap component of the audit performance gap by investigating whether the new EAR reduces the information gap between the users and preparers of the audit report, and if not, it will offer users and preparers suggestions for narrowing this gap.

On the one hand, it is expected that providing more information about the audit would reduce the information performance gap. On the other hand, the extra information might be generic and not the relevant information that users were hoping for. The argument is, expectations gap can be beneficial for auditors as what Power (1999, page 28) describes as “Essential obscurity of Auditing” where:

“Financial auditors have deliberately obfuscated the issue of what audits really do and that this lies at the heart of the expectations gap. If it is impossible to know what financial auditing really produces, then it becomes important to trust practitioners to do their best. And if one does not know what audits are for or what they produce, one does not really know whether they fail either”.

So, in Power’s argument the expectation gap is actually an advantage rather than a disadvantage for auditors.

“The expectations gap, far from being a disadvantage to auditors, is in fact a condition of their economic success. Without an expectations gap there would be full transparency of the audit process, both in terms of its objectives and its production of assurance in relation to those objectives. The market for audit services would be dangerously ‘scrutable’”

(Power 1999, page 31)

2.5 Summary:

This chapter provides the background concepts relating to the nature of audit process and the purpose and objective of financial statements audits. A detailed analysis of the audit report with its different types and its evolution over the years from a one-paragraph audit report to a one-page audit report and eventually into the multiple pages EAR was made looking into the reasons and objectives of these changes over the years. Afterwards the expectations gap in auditing was discussed as one of the main reasons behind the changes to the audit reports over the years. This chapter helps to provide an understanding of the context of the introduction of the EAR and its intended outcomes, to pave the way for an analysis of its effectiveness. In the next chapter I critically analyse the academic literature covering the EAR.

Chapter 3: Literature Review

3.1 Introduction:

This chapter analyses what the academic⁵ and professional literature have contributed to our understanding of the usefulness, informativeness and the production of the EAR both from the users' and auditors' perspectives. Section 3.2 critically analyses the literature on the usefulness of the EAR to its users. Section 3.3 examines the professional literature covering the auditors' views on the production of the EAR. Section 3.4 examines the qualitative literature on audit practice.

3.2 The Usefulness of EAR to its users:

3.2.1 The Informativeness of the EAR:

As indicated in the introduction chapter, the academic research⁶ to date on the informativeness of the EAR involved archival and experimental studies with mixed findings (Bédard et al. 2016; Velte and Issa 2019; Minutti-Meza 2021 and Smith 2023).

In the UK context, Gutierrez et al. (2018) did not find evidence of change in audit quality or in investors' reaction to the EAR in the UK. However, there was mixed evidence with respect to audit fees. They looked for audit reports of 340 non-financial companies traded in London Stock of Exchange (LSE) two years before and two years after the introduction of the extended audit report and used audit fees; absolute discretionary accruals; and three-day cumulative abnormal returns as well as trading volume as proxies for audit costs, audit quality and investors' reaction respectively. They contend that because the information is already available from auditor discussions with the audit committee and the new standard just made them public information it is not costly for auditors and hence do not result in a significant increase in audit

⁵ For a detailed research synthesis of academic research on different types of audit reports including the EAR, see Church et. al 2008; Mock et al. 2013; Bédard et al. 2016; Gimbar et al. 2016 and Velte and Issa 2019.

⁶ See table 3.1 for a summary of all the literature covering the informativeness of the EAR.

fees. However, they did not explain why investors find the extended audit report with no informational value.

Similarly, Lennox et al. (2022) found the auditor risk disclosures have no incremental information content for investors. Moreover, they went beyond Gutierrez et al. (2018) and attributed the uninformative auditor risk disclosures to two possible reasons. First, that these disclosures are irrelevant to investors as the pre-audit risks were mitigated by their substantive tests and client controls and they were no longer risky post-audit tests. Thus, the post audit risk disclosures are irrelevant to investors. Second, that investors already knew about these risks before through other channels. They did not find the risk disclosures by the auditor in the UK extended audit report to be incrementally informative as most of these risks were disclosed in the prior year, so investors were already informed via other channels like conference calls, management earnings forecasts and prior year reports. They examined 488 companies issuing the new audit reports and used short window market reactions by looking at three-day cumulative abnormal return centred on the release date of the extended audit report to capture investors' response to the risks of material misstatements in the new extended audit report. They also used long window tests by looking at the valuation coefficients of earnings per share and net assets and found that the disclosures are relevant to the financial statements but with no incremental information content. As a robustness test, they manually examined half of the sample and found that 65 percent of the risks' disclosures had been already disclosed prior to the issuance of the audit report in conference calls transcripts, management earnings forecasts and prior year reports. Moreover, they didn't find an impact of the new disclosures on the audit fees. This study, however, does not explain or test effectiveness of EARs role in increasing the confidence in the financial statements information and risk disclosures. Because even if the auditor risk disclosures were already known to investors via other channels, the auditor response to these risks and the substantive audit procedures taken to address these risks to make

sure that the management estimates are reasonable and the existing controls mitigate these risks, are only published in the EAR.

Alternatively, Reid et al. (2015), found a reduction in information asymmetry as a result of applying the new disclosure regime in terms of the extended audit report and the audit committee report in the UK. They used abnormal trading volume to test the informativeness of the new disclosures prior to and after the introduction of the new extended audit report and the audit committee report for 293 commercial equity companies traded at London Stock of Exchange (LSE) and found a significant increase in the abnormal trading volume after the first year of adopting the new disclosures which indicate that they are informative to users. The limitation here is that this change could have been caused by other information included in the annual report as there is no empirical way to separate the EAR from the annual report as both are released at the same time.

Moreover, Reid et al. (2019) found that the new disclosure regime resulted in an increase in audit quality evidenced by a decrease in absolute abnormal accruals, and the propensity to meet or beat analysts' earnings forecast which signals a decrease in earnings management 2 years after the introduction of the EAR compared to the 2 years before its introduction. They also found similar to Gutierrez et al. (2018) no significant increase in audit fees or audit report lags as proxies for audit costs and audit delay. Their argument is that the new EAR standards does not involve doing more audit procedures, it just discloses the existing ones that are already performed by auditors. The limitation of this argument is that it does not consider the potential litigation costs impact on auditors from making their risk disclosure available publicly.

Zhang and Shailer (2021), found on average an increase in audit fees as more Risks of Material Misstatements (RMMs) are included in the EAR but no noticeable decrease in audit fees when RMMs are dropped. They contend that the new RMMs which were not identified in the prior

year audit reports or the auditor detailed report to the audit committee, require an increase in the underlying audit efforts and consequently audit fees.

Elamer et al. (2020), investigated the impact of the EAR on firms' cost of borrowing using 2,888 observations of 363 FTSE all share non-financial companies pre and post the EAR adoption. They found that EAR adoption is negatively and significantly related to the pricing and cost of debt. As the number and length of KAMs increase, the lenders' assessment of firms' risks increases which implies the usefulness of the EAR information in the reduction of monitoring costs for lenders. Similarly, Porumb et al. (2019) contend that the EAR reduces adverse selection for lenders who view borrowers with less KAMs as less risky leading to more favourable debt contracting.

The major limitation of the aforementioned archival research is the inability to separate the audit report from the annual report as both are published at the same time, with the annual report containing new information that might cause the change in the abnormal returns or trading volume that are used as proxies for investors reaction. Ball et al. (2012, p. 136), provided evidence in their study of audited financial reporting and management disclosures that cautions against depending solely on the market reactions around the announcement dates as the audited financial reports “*indirectly affects information released at other times and through other channels*”.

Furthermore, another strand of the empirical literature focused on the readability of the new EAR. Smith (2023) examined the effect of the new UK auditor disclosures on the communicative value of the audit report. Using Content Analysis to measure readability and tone of 350 audit reports from companies listed on London Stock Exchange and Irish Stock Exchange as proxies for communicative value and found that audit report readability improves after adopting the new audit report. Similarly, Seebeck and Kaya (2022) using methods from

computational linguistics also found an improvement in proxies for communicative value in terms of readability, visual aids, evaluative content and graphs after the introduction of KAMs for 389 firms with premium listing on LSE. However, they found no evidence that broadly worded KAMs proxies of communicative value are informative to investors while for specific detailed KAMs were valued by investors as they had evidence of significant positive market reactions. These studies while useful have a limitation. They do not provide the full picture or a holistic understanding of the usefulness of the EAR to users, or directly address what users think of the EAR? Or whether it succeeded in restoring auditor's legitimacy as intended by the regulators, policy makers and auditing standard setters? And if it did not what are the reasons behind this failure?

Moreover, another strand of the literature examines the determinants of KAMs. Rousseau and Zehms (2024), examine the impact of audit firm versus audit partner decision style on KAMs reporting in the UK where partner style having more impact than audit firm style. Abdelfattah et al. (2021), found that female audit partners are more likely to disclose more detailed KAMs than male partner in a sample of UK firms from 2013 to 2017 due to behavioural variances between female and male partners.

Hence, my research represents a contribution and an extension on the academic literature on the usefulness of the EAR by complementing these studies with a qualitative approach using semi structured interviews with real users of the UK EAR. This would represent an investment in knowledge diversification and methodological pluralism (Power and Gendron 2015). Additionally, this would address Bédard et al. (2016, p. 259) call for research after the research synthesis of the academic literature covering the EAR:

“Although there have been a number of recent studies, the results have been mixed and do illustrate some possible unintended consequences, such as a disclaimer effect. More research

on whether findings hold for users with greater levels of financial and audit expertise and for additional types of CAM disclosures will be important. Also, more research on how such disclosures are understood by users will be useful”

In other words, by addressing my first research question: Did the EAR succeed in repairing Auditor’s legitimacy? I would address the usefulness of the EAR in terms of its impact on restoring auditors’ legitimacy.

Given the similarity between the extended versions of the audit reports in other jurisdictions and the UK EAR, academic research on the other versions of the EAR informs the analysis of the literature⁷. Bédard et al. (2019) tested the impact of the Justification Of Assessment (JOA) which is similar to the risks of material misstatements in the UK report and have been reported by French auditors since 2003. They tested 953 firm-year observations of large French listed companies from the year 2000 to 2011. They did not find a significant change in market reaction, audit quality, audit costs and audit efficiency which were proxied by absolute cumulative abnormal return around the announcement date, absolute unexpected accruals, audit fees and audit report lag. They concluded that JOA has a symbolic rather than informative value. This finding provides important insights to the potential validity of the extended audit report with a caveat of the different institutional settings of France compared to the UK. Especially the differences in ownership structure and litigation environment in a code law versus a common law system.

In Australia, Moroney et al. (2021) conducted a 2x2 experiment to see the effect of having KAM’s or not and the audit firm size (big 4 vs non-big 4) on the investors perceived value of KAM’s. Using masters students as non-professional investors at a leading Australian university, they found that the inclusion of KAM’s is valued by investors in terms of an increase in

⁷ See table 3.2 for a summary of all the literature covering other versions of the EAR.

perceived value and credibility only when made by a non-big 4 auditor. Users perceive Big 4 auditors to provide high quality audits even in the absence of KAM's. Moreover, they found an unintended consequence of disclosing KAM's that core audit message is less prominent when KAM's are disclosed compared to non-disclosure of KAM's.

Moreover, in the US some experimental studies have been conducted to test the potential impact of applying PCAOB proposed CAM's, which is similar to the risks of material misstatements in the UK report. Bédard et al. (2016) have analysed academic research papers related to the new audit reporting initiatives of FRC, PCAOB and IAASB and analysed 22 studies related to CAMs and found mixed results. They concluded that more research is needed with more sophisticated users in terms of financial and auditing expertise as many of the aforementioned studies use relatively unsophisticated participants. For example, Christensen et al. (2014) conducted an experiment on business school alumni who invest in stocks and analyse financial data by including a CAM paragraph as proposed by PCAOB related to fair value estimates and found that they are more likely to change their investment decision based on a CAM paragraph that is provided by the auditor compared to a standard audit report without CAM disclosures signalling "an information effect" or a CAM disclosure provided in the management notes disclosures signalling "a source credibility effect".

Brasel et al. (2016), contend that the disclosure of critical audit matters offers litigation protection for auditors in the context of the US legal system. Using an experimental study on Jurors, they found that the CAM disclosures reduce auditor's liability in case of undetected misstatements as the risks were more foreseeable to the plaintiff as a result of the CAM disclosure. Therefore, there are legal motives for auditors to increase the quantity of these disclosures with generic standardized boilerplate disclosures, hence diluting the informativeness of the relevant disclosures. Conversely, Backof et al. (2022) conducted an experiment on jurors who found auditors more negligent in case of a subsequently discovered

misstatement that was undetected by auditors when a CAM related to this misstatement and its corresponding audit procedures were disclosed in the audit report ex-ante, compared to non-disclosure of CAM.

Similarly, Kachelmeier et al. (2017) conducted an experiment on attorneys, financial analysts and MBA students and found that they have less confidence on areas listed as CAM in the audit report than other areas not listed as CAM. Hence, the disclosure of CAM reduces the legal exposure of the auditor if a misstatement is later discovered in an area previously listed as CAM which would incentivize auditors to report as many risks as possible in the CAM to reduce their legal exposure leading to an unintended consequence which they called “the disclaimer effect”.

Furthermore, Elliott et al. (2020) using an experimental setting of 325 graduate business students in the US, argue for auditors’ commentary in addition to CAMs in what is proposed in the US as auditors’ discussion and analysis. EARs with auditors’ discussion and analysis that comments on management’s assumptions in terms of how aggressive, neutral or conservative they are, help generate credibility for firms with high financial reporting quality. They found an increase in non-professional investors’ willingness to pay for shares of firms with high financial reporting quality when their financials include auditors’ discussion and analysis.

All the aforementioned studies provide insights about the potential impact of the new EAR. But as they are based on hypothetical formats of the audit report in a lab experiment setting. I contend that by researching the UK experience, it would offer better insights about the effectiveness and informativeness of the new audit reporting model as real-life application of the new audit report with actual users who conceptually are more likely to be more experienced and more sophisticated (Velte and Issa 2019).

Finally, the professional literature, also covered the users' experience and assessment of the usefulness of the EAR. YouGov (2014) was commissioned by the FRC to conduct a study about the users' perception of the value of Auditing in general and the degree of confidence in auditing of different stakeholders in 2014 after concerns by the FRC about the decline of public confidence in Auditing. The research was based on 36 semi-structured interviews with different stakeholders including investors, regulators, policy makers, academics, audit committee chairs, accounting bodies and auditors. They found in general that there is a direct relationship between the degree of confidence in audit and the direct involvement of the stakeholders with the Audit process. Moreover, this research touched briefly on the extended audit report, where it was considered a step in the right direction but still according to one of the investors the results of the audit is poorly presented and it is hard for investors to judge the quality of the audit. Afterwards, YouGov (2016) was also commissioned by the FRC to do a follow-up report in 2016 to measure the progress and developments in audit and how did it impact the level of stakeholders' confidence in audit, using the 2014 report as the benchmark. The 2016 research followed the same methodology of the 2014 research based on 49 semi-structured interviews with stakeholders. A higher level of confidence was found among interviewees compared to 2014. Regarding the extended audit reporting some concerns were raised in terms of the increased length and complexity that adds to the already bulky annual report which might reduce its usefulness. The FRC (2015 and 2016) have issued a report on the experience of the first two years of adoption of the extended audit report, and found that investors welcomed the new changes but there is still room for further enhancements in terms of more information regarding auditor's assessment of the quality of internal controls, assessment of the reasonableness of the estimates used by management and the sensitivity ranges used by auditors, reasons for change in the audit approach and increase in the granularity of the audit reports. Furthermore, the FRC's Audit Quality Reviews presented a positive message however it

signalled instances where some of the audit procedures disclosed in the extended audit report were inaccurate when compared with the actual audit evidence (FRC 2015). Subsequently, the FRC (2022), issued a third review of the EAR in practice. They analysed a sample of 396 EARs of Financial Times Stock Exchange (FTSE) 350 and large Alternative Investment Market (AIM) companies. The main findings were that the EARs varied in size and the degree of boilerplate. Readability score proxies for longer, boilerplate EAR were lower. Challenger (non-big 4) firms have more boilerplate EARs than Big 4. KAM's varies significantly between firms but they have decreased in number since their introduction in 2016, implying the greater resources and access the big 4 have that reduces the cost of having a less boilerplate KAM.

Afterwards, the Brydon review (2019), in relation to the audit report, gave multiple recommendations to enhance the information content of the EAR. First to change the wording of true and fair view in the UK law to present fairly in all material aspects. This will increase the accuracy of the audit opinion and reduce the expectation gap by avoiding the confusion caused by true and fair view. He also recommended to create a continuity between the current EAR and the prior periods EAR by showing the company's responses to prior periods KAM's. Moreover, he called for greater transparency related to estimates by showing "graduated findings" where auditors comment on how conservative, neutral or optimistic the estimates used by the company's management in the financial statements. Another recommendation the inclusion of information by auditors on how the audit judgement was reached, a breakdown of number of hours spent in the audit engagement by seniority of staff and the rationale for the sampling techniques used in the audit engagement. Finally, a disclosure by auditors of any external negative signals observed by auditors and how did they inform the conduct of the audit, whether the information in the annual report reflect the "observed reality" given the auditors understanding and knowledge of the company and any inconsistency in the information in the published information in the annual report (Brydon review 2019).

The limitation of the professional literature is the lack of theoretical depth in explaining why users find some aspects of the EAR useful, and other aspects not so much. They rely predominantly on agency theory information asymmetry perspective and the rational economic agent assumption and fail to consider auditing as a social phenomenon. My research addresses this point by analysing individual users' perspectives informed by the theoretical lens of Suchman's (1995) theory of organisational legitimacy and Sztompka (1999) social theory of trust as explained in chapter 4 the theoretical framework. Hence, gaining an in-depth understanding of how the audit process is dependent on the constantly changing subjective criteria of accountability determined by the society as Flint (1988, p.9) contends:

“Criteria for accountability which are set by the society define the expectation of performance and the audit function undoubtedly fulfils a social function in investigating and reporting on achievement. The really onerous social responsibility of audit, however, derives from the fact that these standards and criteria are to a greater or lesser extent subjective and are continually evolving. The social responsibility of the audit is to interpret dynamically, and not statically and inflexibly, the meaning and thus the expectation of the audit requirement which is imposed by law or by agreement in a particular set of circumstances.”

Study	Objective	Methodology	Findings	Explanation of the Findings
Reid et al. (2015)	Are Auditor and Audit Committee Report Changes Useful to Investors?	Archival: Using used abnormal trading volume to test the informativeness of the new disclosures prior to and after the introduction of the new extended audit report and the audit committee report for 293 commercial equity companies traded in LSE.	Abnormal trading volume significantly increased after the implementation of the new disclosure regime signalling its informaiveness to investors.	Agency Theory: Reduction in information asymmetry
Reid et al. (2019)	The Impact of Auditor and Audit Committee Report Changes on Audit Quality and Costs	Archival: 696 firm year observations of companies traded at LSE while using absolute abnormal accruals, propensity to just meet or beat forecasts expectations as proxies for audit quality.	The new disclosure regime resulted in an increase in audit quality and no significant increase in audit fees	Increase in auditors' professional scepticism

Smith (2023)	The effect of the new auditor disclosures on the communicative value of the audit report.	Archival: Using Content Analysis to measure readability and tone of 350 audit reports from companies listed on London Stock Exchange and Irish Stock Exchange to measure their communicative value.	Audit report readability improves after adopting the new audit report.	Communication Theory where auditors improved their message (the audit report)
Lennox et al. (2022)	Is the expanded model of audit reporting in the UK informative to investors?	Archival: 488 companies issuing the new audit reports, using used short window market reactions by looking at three-day cumulative abnormal return centred on the release date of the extended audit report and long window tests by looking at the valuation coefficients of earnings per share and net assets.	Audit report disclosures are relevant to the financial statements but with no incremental information content.	Institutional Theory Isomorphism and Legitimacy Theory: Absence of new information in the audit report
Gutierrez et al. (2018)	The consequences of the new auditor's report in the U.K., in terms of audit costs, audit	Archival: 340 non-financial companies traded in LSE two years before and two years	No evidence of change in audit quality or in investors' reaction to the extended audit	

	quality, and investors' reaction	after the introduction of the extended audit report and used audit fees; absolute discretionary accruals; and three-day cumulative abnormal returns as well as trading volume as proxies for audit costs, audit quality and investors' reaction respectively.	report in the UK however, there was mixed evidence with respect to audit fees.	Institutional Theory Isomorphism and Legitimacy Theory
Zhang and Shailer (2021)	Does changes in Auditor RMMs result in a change in Audit effort and Audit fees?	Archival: 3,062 observations of non-financial companies listed on the London Stock Exchange that are years ending on and after September 30, 2013 and before September 30, 2019,	On average there is an increase in audit fees as more Risks of Material Misstatements (RMMs) are included in the EAR but no noticeable decrease in audit fees when RMMs are dropped.	They contend that the new RMMs which were not identified in the prior year audit reports or the auditor detailed report to the audit committee, require an increase in the underlying audit efforts and consequently audit fees.
Elamer et al. (2020)	The impact of the EAR on firms' cost of borrowing	Archival: 2,888 observations of 363 FTSE all share non-financial	EAR adoption is negatively and significantly related to the pricing and cost of debt.	Agency Theory: Reduction in information asymmetry

		companies pre and post the EAR adoption	As the number and length of KAMs increase, the lenders' assessment of firms' risks increases which implies the usefulness of the EAR information in the reduction of monitoring costs for lenders.	
Seebeck and Kaya (2022)	The impact of KAMs on proxies of communicative value	Archival: 389 firms with premium listing on LSE	Improvement in proxies of communicative value after implementation of EAR. For general KAMs no evidence of being informative to investors. For more specific KAMs a positive significant capital market reactions existed.	Investors value detailed and specific KAMs.

Table 3.1: Summary of the literature covering the usefulness of UK EARs

Study	Objective	Methodology	Findings	
Bédard et al. (2019)	The impact of the Justification Of Assessment (JOA) on market reaction, audit quality, audit costs and audit efficiency.	Archival: Using 953 firm-year observations of large French listed companies from the year 2000 to 2011. Absolute cumulative abnormal return around the announcement date, absolute unexpected accruals, audit fees and audit report lag were used as proxies for market reaction, audit quality, audit costs and audit efficiency respectively.	No significant change in market reaction, audit quality, audit costs and audit efficiency. They concluded that JOA has a symbolic rather than informative value.	Institutional Theory Isomorphism and Legitimacy Theory
Christensen et al. (2014)	How non-professional investors respond to CAM's disclosures related to the auditing of fair value estimates?	Experimental: Using 141 business school alumni who invest in stocks and analyse financial data.	Non-professional investors are more likely to change their investment decision based on a CAM paragraph that is provided by the auditor compared to a standard audit report without CAM disclosures signalling "an information effect" or a CAM disclosure provided in the management notes disclosures signalling "a source credibility effect".	Agency Theory: Reduction in information asymmetry
Brasel et al. (2016)	The Effects of CAM's disclosures on Judgments of Auditor Liability	Experimental: Using 528 Jury eligible individuals from Amazon's Mechanical Turk.	The disclosure of critical audit matters offers litigation protection for auditors in the context of the US legal system	Litigation Costs Hypothesis

Kachelmeier et al. (2017)	The effects of CAM's disclosures on the Auditor's legal exposure.	Experimental: Using 150 MBA students, 50 financial analysts, 23 class-action attorneys, and 47 non-class-action attorneys	CAM's disclosures reduce auditor legal exposure.	Litigation Costs Hypothesis
Backof et al. (2022)	The Effects of CAM's disclosures on jurors' assessment of Auditor Negligence	Experimental: Using 181 Jury eligible individuals from Amazon's Mechanical Turk and 161 Jury eligible individuals from Qualtrics Panel Management.	The disclosure of critical audit matters increases jurors' negligence assessment.	Litigation Costs Hypothesis
Elliott et al. 2020	Do Investors Value Higher Financial Reporting Quality, and Can Expanded Audit Reports Unlock This Value?	Experimental: Using 325 graduate business students in the US	Auditors' commentary in addition to CAMs about management's assumptions increase non-professional investors willingness to pay for shares of firms as it gives credibility and signals high financial reporting quality.	Cooperation literature in social and evolutionary psychology
Moroney et al. (2021)	When do investors value KAM's?	Experimental: Using masters students as non-professional investors at a leading Australian university.	The inclusion of KAM's is valued by investors in terms of an increase in perceived value and credibility only when made by a non-big 4 auditor.	Legitimacy Theory Users perceive Big 4 auditors to provide high quality audits even in the absence of KAM's

Table 3.2: Summary of the literature covering the usefulness of other versions of EARs

3.2.2 Literature covering the impact of Audit Reports on the Expectations Gap:

Prior research was conducted on the previous versions of audit reports⁸. Academic research on the short form audit reports, using questionnaires, interviews, focus groups and analyzing stakeholders' responses to proposed audit reporting initiatives, found that users need more information about the audit process and that the audit report has a symbolic value with little communicative value and suggested including additional disclosures in the audit report (Church et al. 2008; Coram et al. 2011; Vanstraelen et al. 2012; Mock et al. 2013; and Simnett and Huggins 2014).

In the UK, Hatherly et al. (1991) used a UK derivative of the US expanded audit report SAS 58 to see whether it improve the users' understanding of the audit process and reduce the reasonableness component of the audit expectations gap in an experiment using 140 part-time MBA students with business experience and no formal education or training in auditing as a proxy for a "reasonably intelligent" user. They were divided into two groups with one group having a short form audit report and the other group having an expanded audit report, and then both groups were asked to fill a questionnaire about their perceptions of auditing. They found that the expanded report significantly changed the users' perceptions to better understand the roles and responsibilities of auditors and the audit process. However, they observed a "Halo effect" which is a spillover effect resulting from an overall sense of wellbeing after reading the expanded audit report that include issues not stated in the report for example the impression that the financial statements are free from fraud. This "Halo effect" might increase the expectations gap instead of reducing it.

Similarly, to test the impact of SAS 600 issued by the APB, Innes et al. (1997) used a postal questionnaire sent to 500 Scottish auditors with 254 respondents as well as - in a laboratory

⁸ For a detailed research synthesis of academic research on audit reports see Church et. al 2008; Mock et al. 2013 and Bédard et al. 2016.

setting - questionnaires for 140 part-time MBA students divided into two groups one with the short form audit report included and the other with a version of the expanded audit report. Based on the answers received from questionnaires they found a difference between what users perceive auditors are doing and what auditors perceive they are doing. They found that a reasonableness gap exists between users and auditors in UK short form audit reports and on balance, the expanded audit report brought users' perceptions closer to auditors' perceptions. However, they found for some aspects, for example fraud, the users' perceptions moved further away from the auditors' perceptions creating a "Halo Effect". So, it has a useful but limited impact on the expectations gap.

Arguing that excessive standardisation leads to reducing the usefulness of audit reports to users, Hatherly et al. (1998) proposed a free-form audit report. This report would be uniquely tailored to each audit engagement, to depart from the standardized generic audit report. They conducted an experiment using 100 part-time MBA students divided into two groups (50 each) completed a questionnaire, with one group having the SAS 600 expanded audit report as well as a free form audit report and the other with only the expanded audit report. The report form used in the experiment was supplied by a Big 6 audit firm that they use for private communications with their clients' board of directors. They found that free-form audit reports increase the users' perceptions of the rigour and usefulness of the audit. This study follows the constructive approach focusing on improving the informational value of the audit report. This finding is consistent with the findings of the regulatory bodies' current outreach activities that documented investors demand for granular information about each audit client.

Manson and Zaman (2001) used a questionnaire survey in 1999 sent to 400 auditors, 200 users and 400 preparers to test whether SAS 600 expanded audit report was successful in aligning their views. The main premise here is that the users' views about the roles and responsibilities of auditor are incorrect and they need to be educated via the audit report to readjust their views

to match those of the audit profession. They found that it succeeded in clarifying the purpose and responsibilities of the auditor but needed to add more details on the findings of the audit. Also, it was less successful in clarifying the auditor responsibility regarding fraud and illegal acts. Again, here the focus was on the reasonableness gap component of the audit expectations gap. See table 3.3 for a summary of the academic literature covering the impact of Audit Reports on the Expectations Gap.

In the aforementioned studies the SAS 600 expanded audit report represents an example of the defensive approach from the audit industry towards the audit expectations gap that focuses on educating users. This was done by introducing a scope paragraph that specify the scope and responsibilities of the financial statement audit and contrast it with the management (auditee) responsibilities. However, as Porter et al. (2012) found that the users in the UK in their study are already aware of the auditor responsibilities, the focus should be more on the performance component of the expectations gap. Furthermore, as Vanstraelen et al. (2012) contend many of the primary users of the audit report are sophisticated enough such as institutional investors, financial analysts and bankers. Hence the focus of my study would be on the performance component of the expectations gap and specifically on the information gap by testing the effectiveness of the new extended UK audit report.

Furthermore, as argued by Sikka (2009), the “intensification of finance capitalism” in terms of more sophisticated business models especially in the financial sector that can be found in banks and hedge funds new inventions of complex derivatives and financial instruments cast serious doubt on the competence and skill set of auditors. As most of the existing audit training and audit techniques rely on traditional methods appropriate for tangible assets not the financially engineered derivatives. So, the question becomes, do we need a new auditing technology to cope with these lengthier sophisticated annual reports and the increased expectations from auditors?

Given these developments, my study would provide new insights to extend and contribute to the literature on UK Audit reports by extending the focus to the new UK EAR's impact on the information gap component of the audit expectations gap.

And since the new extended audit report provides granular information about each audit engagement in terms of key audit matters and materiality levels and how the scope of the audit was tailored given the risks and materiality levels, thus the increase in the transparency about the auditor's work is expected to reduce the performance gap component of the audit expectations – performance gap. This update is also a shift from the defensive approach (Humphrey et al. 1992) which assigns blame on users' misconceptions about the nature of the audit process to the constructive approach of improving the audit report informational value as a signal of audit quality. This expectation is supported by the research done by Vanstraelen et al. (2012) who found that the new proposed changes to the audit report have the potential of reducing the information gap component of the audit expectations gap, after interviewing ten audit report users (analysts and bankers) from the EU and ten audit report preparers (managers and partners from big 4 and non-big 4 EU audit firms) and finding a common ground between the users' information needs which are at the same time cost beneficial for auditors to provide. However, this study was based on a hypothetical scenario not the actual practical case where the new information might be informative or just standardized uninformative boilerplate due to the competing forces discussed earlier in chapter 1.

Conversely, Coram and Wang (2021) conducted an experiment on 240 non-professional financial statements users recruited from Amazon Mechanical Turk in the United States to determine the impact of disclosing KAMs on the audit expectations gap. They found no evidence in general that KAMs relating to general less precise accounting standard make any difference on the audit expectations gap. And KAMs relating to more precise accounting

standard increase the users' expectations resulting in an unintended consequence of increasing the reasonableness component of the audit expectations gap.

Professional literature also found the persistence of the expectations gap after the introduction of the EAR. YouGov (2014) study found that the expectation gap still exists. Afterwards, YouGov (2016) also found that the expectations gap still exists, and more guidance is needed regarding expanding the remit of auditing.

Brydon (2019, p. 22), argues that the huge focus on the expectations gap is a distraction:

“I find all this focus on the expectations gap is a distraction. Either audit is helping to reinforce deserved confidence in business or it is not. What is required is better audit delivered by professionals in a more understandable framework.”

Addressing the first, second and third research questions will indirectly contribute to the literature on the audit expectation gap, by finding whether the EAR successfully reduce the information gap component of the performance audit expectation gap and the reasons for its failure if it did not succeed.

Study	Objective	Methodology	Findings	Explanation of the Findings
Hatherly et al. (1991)	Whether a UK derivative of the US expanded audit report SAS 58 improves the users' understanding of the audit process and reduce the expectations gap.	Experimental: 140 part-time MBA students divided into two groups (70 each) completed a questionnaire, with one group having the short form audit report included and the other with the expanded audit report.	The expanded report significantly changed the users' perceptions to better understand the roles and responsibilities of auditors and the audit process. However, they observed a "Halo effect" which might increase the expectations gap instead of reducing it.	Users became more aware of the role and responsibilities of the auditor and thus the reasonableness gap component of the expectations was reduced.
Innes et al. (1997)	Is there an audit expectations gap in UK short form audit Reports? What is the impact of the expanded audit report on the audit expectations gap?	Experimental: Postal questionnaire survey sent to a random sample of 500 Scottish auditors with 254 respondents and in a laboratory setting questionnaires for 140 part time MBA students divided into two groups (70 each) one with the short form audit report included and the other with the expanded audit report.	A gap exists between users and auditors in UK short form audit reports. On balance, the expanded audit report brought users' perceptions closer to auditors' perceptions.	Users became more aware of the role and responsibilities of the auditor and thus the reasonableness gap component of the expectations was reduced.
Hatherly et al. (1998)	Whether a free-form audit report changes users' perceptions about the audit process?	Experimental: 100 part time MBA students divided into two groups (50 each) completed a questionnaire, with one group having the SAS 600 expanded	Free form audit reports increase the users' perceptions of the rigour and usefulness of the audit.	Granular information about each audit client reduced the information gap

		audit report as well as a free form audit report and the other with only the expanded audit report.		components of the expectations gap and increased the confidence in auditing.
Manson and Zaman (2001)	Whether SAS 600 expanded audit report was successful in aligning the views of prepares, users and auditors of the financial statements.	Questionnaire survey to 400 auditors, 200 users and 400 preparers of financial statements	They found the expanded audit report is successful in clarifying the purpose and responsibilities of the auditor but needed to add more details on the findings of the audit. Also, it was less successful in clarifying the auditor responsibility regarding fraud and illegal acts.	Users became more aware of the role and responsibilities of the auditor and thus the reasonableness gap component of the expectations was reduced.
Coram and Wang (2021)	The effect of KAMs on the audit expectation gap for non-professional users	Experimental: 240 non-professional financial statements users from Amazon Mechanical Turk in the United States.	In general, no evidence that KAMs make any difference on the audit expectations gap. The gap increases when KAMs relates to a precise accounting standard (objective KAM)	Users have higher expectations of reliability from objective KAMs which further increase the reasonableness gap.

Table 3.3: Summary of academic literature covering the impact of Audit Reports on the Expectations Gap

3.3 Literature covering the auditors' views on the production of the EAR:

Looking at the literature in section 3.2, all the academic research only focusses on the audit effort using proxies like audit fees and audit report lag (For e.g. Reid et al. 2019; Gutierrez et al. 2018). They do not address the experience of the auditors in the production of the EAR. YouGov (2016) partially addressed the auditors' experience without theoretical analysis. Their study showed concerns voiced by auditors about increased liability for audit firms as a result of the increased disclosures arguing that auditors have unlimited liability which make the auditors think twice before disclosing information.

Hence, to the researcher's knowledge, this research is the first academic research to study the process of the production of the EAR by the auditors. This will be done through analysing the auditors' interview data using the theoretical lens of the audit comfort framework as explained in chapters 4 and 7. By doing so, the research will address the relative scarcity identified in the literature of in-depth research with direct engagements with auditors to gain their perspective (Gendron & Spira 2010; Humphrey 2008; Power 2003 and O'Dwyer et al. 2011).

3.4 Qualitative literature on audit practice:

This study also extends the qualitative literature on audit practice by directly engaging with practicing auditors to capture their experience and helps to bridge the gap between academic scholarship and accounting practice (Kaplan 2011). By entering the field and examining the backstage of audit practice our understanding of auditors' organisational reality is enhanced. This study adds to the qualitative audit research literature and represents an investment in knowledge diversification and methodological pluralism which complements the archival and experimental literature on audit practice to obtain more holistic understanding (power and Gendron 2015).

Pentland (1993) conducted a field observation of 2 audit engagements and applied Collin's theory (1981) of interaction ritual chains and found that auditing as a ritual produces comfort, as a result of audit team members' interactions that transform the annual accounts of a company from an untrustworthy to trustworthy form that both auditors and the public are comfortable with.

Carrington and Catasus (2007) interviewed twenty audit seniors to investigate how auditors perceive the production of comfort. They adopted a classification scheme from nursing practice developed by Kolcaba and Kolcaba (1991). This scheme consists of three senses of comfort: relief sense involving the actions that produce comfort by relieving discomfort, state sense which represents an inventory of comforts and discomforts and renewal sense that involve new perceptions of acts that relieve discomfort. They found that to attain a state of comfort auditors need to make a decision that sufficient discomforts have been relieved.

Moreover, Commerford et al., (2016) conducted semi-structured with twenty experienced auditors. They examined the extent of real earnings management's impact on auditors' discomfort and identified how auditors use comfort building strategies to move from discomfort to comfort. They described a "Two-pronged" approach applied by auditors, using their audit rituals and procedures to build or re-establish comfort "rationality" and their body senses and emotions "gut feel" to identify risks. Similarly, Humphrey and Moizer (1990) found a similar finding related to the "gut feel" used in audit judgement when they analysed the audit planning process when they interviewed 18 audit managers in Manchester, England. Furthermore, Guénin-Paracini et al. (2014) did an ethnographic study in a French branch of a big audit firm and found that auditors experience fear or discomfort as the "emotional experience of risk" at the start of the audit and strive to alleviate that discomfort via their procedures to reach comfort to give an audit opinion.

Hence, my study would extend the audit comfort literature in the context of auditors' experience in the production of the EAR.

More generally it would extend the qualitative literature that capture the experiences of auditors in the field. For example, Dodgson et al. (2020) conducted 20 semi-structured interviews with US audit partners to understand how the relationship between the auditor and auditee is managed via the audit partner rotation using the theoretical lens of social exchange theory. Gendron and Spira (2010) conducted 25 interviews with former Arthur Anderson employees to make sense of their organisational and professional identity in the aftermath of failure. Carlisle et al. (2023) explored the power dynamics during the collection of audit evidence by conducting 22 semi-structured interviews with associate and senior auditors who interact with top management of the auditee. They found that auditee personnel maintain the upper hand which leads to behaviours that threaten audit quality by junior auditors such as client avoidance and ghost ticking. Xu et al. (2023) conducted 35 semi-structured interviews with junior and senior auditors in New Zealand to capture auditors' perceptions and experiences of exercising professional skepticism in practice.

Chapter 4: A Possible Theoretical Framework for Analysing the Impact of the UK

Extended Audit Report

4.1 Introduction

As discussed in the literature review in chapter 3, the majority of the academic and professional literature, utilise agency theory to explain the need for auditing and how auditing can be useful to its different stakeholders. Additionally, given the FRC, IAASB, PCAOB and the rest of auditing regulators outreach activities and consultations, the task of extending the audit report was aimed to be a technological intervention to bridge the information gap between users and preparers of the audit reports and open the black box of auditing (FRC 2022).

The intended outcome was to restore and repair auditors' strained legitimacy by the introduction of the Extended Audit Report (EAR), and therefore I got to my first research question:

RQ1: Did the EAR succeed in repairing Auditor's legitimacy?

Given my abductive research approach discussed in detail in chapter 5, I went to the field and started to talk to the users of the EAR to address the research question. Given, the shortcomings and mixed findings of positivist and functionalist agency theory framework identified in the literature discussed in chapter 3 mainly the inability to separate the EAR from the annual report as both are published in the same time, an interpretivist research was conducted using legitimacy theory as the theoretical lens (Suchman's theory of Organisational legitimacy 1995) to get an in depth view of the users' assessment of the effectiveness of the EAR in achieving its intended outcome. However, during the data collection, the fieldwork data showed that it is a trust problem, as well as a legitimacy problem as users do not always trust auditors to deliver the outcomes of the audit findings faithfully. The data showed that users have serious doubts on the independence, competence and accountability of auditors. These doubts stem from the

political economy context within which the principal agent relationship exist outside the standard agency theory framework. Incentive structure for auditors, audit market concentration (Oligopoly), provision of non-audit services, audit tenure, audit rotation, the way auditors are hired, auditors' remuneration, and regulatory capture were the main themes identified in the interview data that affect users' trust in the audit process and audit report.

Consequently, capitalising on the theoretical flexibility of the abductive approach, I went back to Sztompka (1999) sociological theory of trust to provide an in-depth analysis of the sources of trust to understand why the EAR failed to restore the legitimacy to auditors themselves. This analysis led to the second research question:

RQ2: Do users trust the information in the EAR?

Taken together, legitimacy and trust theories, helped me in producing a "Theorised storyline" (Golden-Biddle and Locke 2007) about the impact of the EAR on its users.

Furthermore, in order to obtain a holistic in-depth understanding of the EAR, I went to the field to talk to the preparers of the EAR (auditors) to get their reflections on the users views and to understand the process of producing the EAR through the theoretical lens of the audit comfort framework (Pentland (1993); Carrington and Catasus (2007); and Commerford et al., (2016)). Hence, address my third research question:

RQ3: What is the auditor's experience of implementing the EAR? What are their reflection on the concerns raised by users?

The rest of the chapter is structured as follows: section 4.2 discusses the problematic nature of agency theory in the context of auditing and the EAR. Section 4.3 discusses Suchman's legitimacy theory (1995), its analytical typology and its application to the EAR to address the first research question. Section 4.4 discusses the application of Sztompka (1999) sociological

theory of Trust to the EAR to address the second research question. Section 4.5 discusses the audit comfort framework (Pentland (1993); Carrington and Catusus (2007); and Commerford et al., (2016)) and how it is applied to the EAR to address the third research question. Finally, section 4.6 provides a summary.

4.2 The Problem with Agency theory in Auditing:

“Accountants, as auditors, have cemented their status and privileges on the basis of claims that their expertise enables them to mediate uncertainty and construct independent, objective, true, and fair accounts of corporate affairs.”

(Sikka 2009, p. 868)

In this section, I critically analyse the role of agency theory by presenting the argument mobilised in the literature for using the agency theory framework in auditing and the EAR. Followed by the shortcomings of agency theory and why a different theoretical lens is needed in the context of my research.

4.2.1 Argument for agency theory:

Agency theory has been used historically as the main theoretical lens to understand the role of financial accounting and auditing processes in the literature (Cohen and Holder-Webb 2006; ICAEW 2005; Watts and Zimmerman 1983). According to the agency theory, separation of ownership and control, result in an agency problem between the principal (current shareholders) and the agent (managers), as agents have insider information that is not available to principals resulting in information asymmetry and the risk of Moral Hazard. Hence, financial statements and disclosures in the annual report serve as a signalling tool to reduce the information asymmetry. However, Agency Theory argues that since managers (agents) are inherently biased, they can act opportunistically to pursue their own self-interest and maximize their own utility (in terms of bonuses, stock compensation, empire building, prestige and other perks) at

the expense of the principal's interest. Hence, Auditing as an expert knowledge, represents a monitoring mechanism to ensure that agents perform their duties to serve the best interest of the principal, and to express an opinion on the fairness of the accounting numbers in accordance with the related accounting standards. In other words, auditing is one of the solutions to the agency problem. Auditors as agents themselves are supposed to be independent from the other agents (managers). As a result, auditors reduce the information risk of financial statements amounts and disclosures, which is the risk that users of the financial statements make their decisions based on incorrect information. Thus, it is argued, auditing helps with the efficient allocation of resources and reducing under investing in capital markets. This monitoring role makes the auditors part of the corporate governance mosaic as a complement for independent audit committees and internal auditing (Jensen and Meckling 1976; Fama and Jensen 1983; Watts and Zimmerman 1983; and Cohen et al. 2002).

Applying this to the EAR, the increased information disclosures by the auditors should be expected to reduce the information asymmetry and result in more useful reports and repairing the auditors' strained legitimacy. However, based on the interview findings and mixed findings in the prior literature, identified in Chapter 3 this is not always the case. As Sikka (2009, p. 868) contends:

“The claims of expertise are frequently punctured by unexpected corporate collapses, frauds, and failures. Such events fuel the suspicions that auditors lack the requisite independence, expertise and incentives to construct the promised ‘true’ and ‘fair’ account of corporate affairs.”

4.2.2 Shortcomings of the agency theory:

Auditing represents a complex expert practice, which require an in-depth understanding and analysis (Power and Gendron 2015). As explained in chapter 5, I am using an interpretivist

paradigm, a relativist ontology, where I believe that there are multiple realities that are created through shared individuals' subjective experiences. Where different people can experience the same event differently. To understand these multiple realities the individual experiences, need to be understood and interpreted by talking to the people who experience these realities and are experts of their own experiences. This does not fit with agency theory functionalist positivist view, which assumes that utility maximisation is the only motive for human actions and assumes a single objective reality of rational economic agents with the sole purpose of utility maximisation. This ignores moral and ethical motives that could influence the human action (Rutledge and Karim 1999). This deterministic view of human actions fails to address my research questions and account for the complexities and mixed findings identified in the literature review (Armstrong 1991).

Furthermore, Agency theory has been criticised as being too simplistic (ICAEW 2005). Its limited focus on contracts, monitoring and incentives does not take into account the complexities and nuances in real empirical settings. For example, agency theory argument is that auditors can be trusted as they act as a repeat player who have the competence and expertise from auditing various clients. They have a reputational capital that they need to maintain, so ideally, they have an incentive to avoid the risk of decline in this reputational capital by providing informative audit reports that signal the quality of their work, since the loss of reputation of the audit firm as a whole far exceeds the gains from any single audit client (Coffee 2006). However, agency problems might exist within the audit firm (the principal), where auditors of one office (agents) might want to acquiesce with the client to generate private benefits or reach individual fees targets. This risk of "agent capture" by the auditee depends on the quality control measures and the degree of monitoring within the audit firm regarding their individual audit partners and how often the audit firm rotates its audit engagement partners. As a case in point, what happened in the demise of Arthur Anderson. It did not make sense for the

global firm to acquiesce in Fraud with Enron, as they have so much to lose, and Enron fees is immaterial to the global firm. However, at an individual partner level for the Houston office, Enron was too big as a client with huge percentage of their total fees' revenue coming from Enron (Coffee 2006).

So, the question is who should audit the auditors? As auditors are, similar to managers, agents and might have conflicts of interests and agency costs that lead them to act opportunistically. Currently regulatory bodies like the FRC in the UK and the PCAOB in the US audit the auditors. Again, concerns about the incentives of the regulators and the regulatory capture arise. As questions about the link between regulators and the big audit firms raises the risk of regulatory capture. As a recent discovery in the US where five senior officials from KPMG got confidential audit inspection lists from the PCAOB (SEC 2019).

Additionally, from a regulatory perspective, auditors especially the big 4 are becoming too big to fail and given that the big 4 audit the majority of PIEs, the market can't afford the collapse of another Arthur Anderson. This is evident in the resilience of big 4 audit firms in the face of audit failures, paying huge amounts of fines and settlements for lawsuits (for e.g. see FT 2022b where KPMG paid £1.3bn over Carillion audits). As Power (1999 p. 126) argues:

“Audit arrangements emphasize the production of comfort, this reflects an institutional need for auditing not to be too ‘successful’ in finding problems and in producing discomfort by reporting these problems. This tension between comforting and criticizing has deeper implications for the role of auditing as a basis for public dialogue.” Where regulators and politicians do not want systemic doubts about audit (Power 1999).

And so where does the endless monitoring stops? How is trust achieved and what are the sources of trust? All these questions cannot be answered using the agency theory framework.

To sum up given the limitations discussed above, mixed findings in the literature and the interview findings, there are externalities and overflows (Callon 1998) outside the boundaries of agency theory that affect the users' assessment of the usefulness of EAR and the repairing of auditors' legitimacy. Thus, a more in-depth understanding of the different forces impacting the effectiveness of the EAR is needed. This is done via an interpretivist approach using legitimacy, trust and audit comfort framework to address the three research questions.

In the next section, Suchman's (1995) theory of organisational legitimacy is analysed as the theoretical lens to answer the first research question.

4.3 Suchman's Theory of Organisational Legitimacy:

4.3.1 Definition of Organisational Legitimacy:

The way professions legitimate their work is by connecting:

“professional diagnosis, treatment, and inference to central values in the larger culture, thereby establishing cultural authority”

(Abbott 1988, page 184)

The concept of legitimacy and legitimization activities in the audit and assurance literature is generically defined, so there is a need to refine them to focus on which specific type of legitimacy and legitimization activity is being pursued (O'Dwyer et al. 2011). Following O'Dwyer et al. 2011, who applied Suchman's 1995 theory of Organisational legitimacy into the assurance of sustainability reporting, I am going to use it as the theoretical lens to look at the informativeness of the EAR. The reason for choosing Suchman's (1995) theory in this study is that he breaks down organisational legitimacy into three analytical types: pragmatic, moral and cognitive legitimacy. Each type has its own sub-types that allow for a more in-depth understanding and analysis of whether the EAR restored auditor's legitimacy. Furthermore, it shows which analytical type it succeeded to achieve, and which ones failed. Given the data

findings explained in chapters 5 and 6, Suchman's theory provided the best theoretical analysis of the users' interview data findings.

Organisational legitimacy is a fundamental quality for auditors to maintain their reputational capital. If auditors lose their reputational capital, they will lose all their audit clients. For e.g. the demise of Arthur Anderson after its audit failures with Enron and Worldcom. The Big 5 became Big 4 and it was not because of the litigation costs and fines, it was a case of losing reputational capital and organisational legitimacy (Coffee 2006).

Suchman (1995 p. 574) defines organisational legitimacy as:

“Legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions.”

He contends that it represents a general perception possessed objectively by a group of observers who subjectively create that perception about an organisation as they witness it. It is socially constructed because of the congruence between the legitimated entity and the social norms and beliefs of the target social group (Suchman 1995; Deegan 2019).

According to Suchman, Legitimacy is dependent on the collective audience and independent of the individual observer. Consequently, negative adverse incidents can be dismissed as outliers. Applying this to auditing, the users of the audit function as a collective have a perception about the legitimacy and usefulness of auditing based on socially constructed concepts of true and fair view, transparency, stewardship, monitoring and protecting public interest, even with frequent audit failures, which are being dismissed as unique occurrences.

Applying Suchman's (1995) argument on the role of organisational legitimacy against the backdrop of the introduction of the EAR, auditors communicate more to users in the audit report. They talk about the nature of the audit process in terms of KAM's, how materiality is

reached and how they impacted the scope of audit work. The audit process becomes more meaningful, understandable, predictable and most importantly trustworthy.

4.3.2 Types of Organisational Legitimacy:

Suchman (1995) distinguished three analytical types of legitimacy: Pragmatic, Moral and Cognitive Legitimacy and broke them down into subtypes based on their focus and temporal dimensions.

A Typology of Legitimacy		
	Actions	Essences
Episodic	Exchange	<i>Disposition</i>
Continual	Influence	Interest
		Character
Episodic	Consequential	Personal
Continual	Procedural	Structural
Episodic	<i>Comprehensibility</i>	<i>Predictability</i>
		<i>Plausibility</i>
Continual	<i>Taken-for-Grantedness</i>	<i>Inevitability</i>
		<i>Permanence</i>

Figure 4.1: Suchman's Typology of Legitimacy (1995, page 584)

1. Pragmatic Legitimacy, based on the self-interest of the target audience. He then classified pragmatic legitimacy into three subcomponents: Exchange, Influence and Dispositional legitimacy.

Where in *Exchange legitimacy* the organisational actions affect the audience well-being. The focus is on organisational actions on the short term (Episodic Basis). In the EAR context, auditor opinion, KAM's and materiality levels affect the ability of investors to rely on the financial statements of the company, reliability of the auditee's financial statements and the reputational capital and legitimacy of the audit firms. As for *Influence legitimacy*, the organisation invites the audience to be part of the decision and policymaking, and again the focus here is on the actions of the organisation but on a continual basis. In the EAR context, the regulators conducted outreach activities to different audience and stakeholders when developing the EAR standard. These outreach activities signal that the profession is interested in the audience interests not just its own.

Finally, *Dispositional legitimacy* where audience give legitimacy to organisations that share the same values that they hold. Here, the focus is on the essence of the audit firms not its actions. Auditors achieve dispositional legitimacy by linking users shared values to that of the auditors. For e.g., the big 4 audit firms being associated with professionalism, high quality audits, scale, hiring experts and acquiring talent, then incidents of audit failure delegitimizing effects can be mitigated (Suchman1995).

2. Moral Legitimacy, which represents normative legitimacy and is "sociotropic", it is not based on the self-interest of the user or the evaluator but whether the activity represents "the right thing to do" according to the audience's socially constructed view. He then classified moral legitimacy into four subcomponents: Consequential, Procedural, Structural and Personal legitimacy.

Consequential legitimacy focuses on outcomes and consequences of an organisation's action with an episodic focus. For e.g. rates of mortality at hospitals, academic test scores. However, for some organisations the outputs are inherently difficult to measure, for e.g. in audits what

constitutes a successful audit and high audit quality is difficult to measure and depends on the evaluator's socially constructed definition of success.

Procedural legitimacy, using socially accepted science like techniques (for e.g. statistical sampling and business risk audit (Power 1999)) to achieve moral legitimacy. The focus here is on the organisational actions on a continual basis. It becomes particularly important when the outputs are invisible as in the case of audits. Shedding a light on the audit procedures black box in the EAR is expected to give the auditor procedural legitimacy as science like methods that represent socially accepted procedures of calculating materiality and identifying and addressing KAM's where consequential legitimacy is not clearly visible in the outcome of audits where no fraud cases are discovered. Using Suchman's (1995) example to highlight the importance of procedural legitimacy in achieving moral legitimacy, a hospital would lose its legitimacy if it conducts exorcisms, even if the patients get better, while it is unlikely to lose it because of the death of some patients. Applying this analogy to auditing, if audit firms establish procedural legitimacy with its audience in the financial statements audit, audit failures can be then dismissed as outliers.

Structural legitimacy, where an organisation is deemed to have a socially constructed capacity to perform its specific type of work being "the right organisation for the job". Here the focus is on the audit firms' essence on a continual basis where they need to establish their capabilities as competent, independent professional service firms capable of performing high quality audits. Finally, *Personal legitimacy*, which involves an evaluation of the charisma, reputation and professionalism of the organisational leaders and personnel with an episodic focus on their essence. In the context of Auditing, that would apply to the users' impressions of the auditor practitioners and their leaders.

3. Cognitive Legitimacy, which represents the highest, strongest, and most difficult to achieve type of organisational legitimacy as it is based on Comprehensibility and Taken-for-

grantedness for organisational objectives and processes. It comprises two subtypes: Legitimacy based on Comprehensibility and Legitimacy based on Taken-for-grantedness.

Legitimacy based on comprehensibility, when audience understand the process and objectives of an organisation. This result in predictability for the auditors' actions and plausibility for their essence. Users accept that auditing is necessary and inevitable, but they do not agree on how effectively it is conducted. The EAR helps to provide more information on how the audit process is carried out and how the audit opinion is reached.

Legitimacy based on taken-for-grantedness, which represents the highest level and the most difficult to achieve with a continual focus on the actions and essence of an organisation. As accounting in general and auditing in particular has the ability of linking actions to values and hence legitimise these actions (Richardson 1987), the institutionalisation of auditing and its role makes it the only acceptable and appropriate course of action and it becomes unthinkable to do away with it. This type is the most difficult to achieve however the most permanent and easiest to maintain.

4.3.3 The EAR as a Legitimacy management tool:

The nature of the legitimating activity can be broken down into strategic and institutional:

Strategic, where organisations purposefully use symbols to gain societal support (managerial perspective).

Institutional, where pressure is generated by “sector-wide structuration dynamics” beyond any single organisational control (detached perspective) (Suchman 1995).

The EAR involves both, as it is imposed by sector-wide pressure after the FRC and the IAASB implemented the EAR standard after public discussions (Coercive Isomorphism) (DiMaggio

and Powell 1983). At the same time, the level of detail and depth of what is included in the report is determined by each audit firm individual discretion.

Focusing on the strategic legitimacy management, organisations can adopt strategies to gain, maintain and to repair legitimacy. As Suchman (1995, page 586) contends, “*legitimacy management rests heavily on communication—in this case, communication between the organization and its various audiences*”. Analysing the EAR as a legitimating tool makes sense, as it is the only visible communication output of the audit process.

During the users interviews it was clear that the interviewed users did not trust auditors as the right social actor for the job. Hence, a theory of trust was needed to analyse the reasons behind these findings.

So, in order to address the second research question, Sztompka Sociological Theory of Trust is analysed in the next section.

4.4 Sztompka Sociological Theory of Trust:

According to Giddens (1990, page 34) trust is:

“the confidence in the reliability of a person or system, regarding a given set of outcomes or events”

He distinguishes between trust in “facework” which involves traditional physical and social interactions and trust in abstract dis-embedded faceless systems like expert systems which auditing is an example of. Giddens (1990, page 27) defines the abstract systems as:

“Systems of technical accomplishment or professional expertise that organize large areas of the material and social environments in which we live today”

The EAR as an abstract object of trust involves a set of complex trust relationships. Trusting the EAR implies more than trusting a report, it relates to trusting individual auditor who prepare

it, the accounting firm where they work, the regulators who oversee their work and the auditing profession as a whole. As Sztompka (1999, page 46) explains: *“we trust who design expert systems, those who operate them, and those who supervise the operations (e.g., pilots, air traffic controllers, and technicians)*

Sztompka (1999) emphasizes this interrelationship between objects of trust. He broke down the sources of trustworthiness into primary and secondary sources. Primary sources of trustworthiness involve Reputation, Performance and Appearance. The reputation part depends on past record of auditors, where they are currently suffering a decline in their reputational capital, because of the major accounting scandals that was not uncovered by auditors (Sikka 2009; FT 2022; FT2023d). The performance part focuses on the current performance, where the EAR highlights what the auditors did in the audit engagement, would be expected to positively influence the users trust compared to the lack of visibility in the older versions of the report (Power 1999). The appearance part is the most contentious one as the auditors are subject to many competing and conflicting incentives and pressures that impair their appearance as in independent trustworthy expert system (Mautz and Sharaf 1961; Flint 1988; Gray et al. 2019).

Secondary sources of trustworthiness include Accountability of trustees and the Context and situations in which the trust relationship exists. For example, face-to-face versus non face-to-face context, interactions with known versus anonymous persons, local vs geographically dispersed situations, and prolonged versus repeated interactions. In the context of Auditing, the regulatory oversight by regulators like the FRC in the UK and the PCAOB in the US who audit the auditors and review their audit reports and compare it to the working papers in their audit files plays a critical role on EAR trustworthiness. Moreover, auditing context of trust for most users, involves non-face to face interactions with anonymous auditors (the exception would be the signing audit partner whose name is disclosed in the UK EAR) in a geographically

dispersed location. Sztompka (1999) contends that legitimacy can be a substitute for trust in a more traditional setting where face-to-face local repeated interactions occur as tradition reduce uncertainty, however in an abstract post-traditional system, trust becomes essential for legitimacy. Auditing as an abstract system with absence of face-to-face interactions, geographically dispersed situations, hence the establishment of trustworthiness would be expected to be more challenging. This matches the interview findings where users indicated a low level of trust in the information content of the EAR and failing to achieve cognitive legitimacy despite acknowledging its success in establishing procedural moral legitimacy.

Therefore, Sztompka (1999) social theory of trust and its sources is used as a theoretical lens to make sense of the findings from the interview data. It was selected by the researcher as it provides the best nuanced understanding of the data findings and provide a richer more in-depth understanding of the impact of the EAR.

To obtain a holistic understanding of the effectiveness of the EAR, the supply side of the EAR is analysed by answering the third research question.

4.5 Audit Comfort Framework:

Audit research is primarily concerned with rationality with less attention to emotions (Guenin-Paracini et al. 2014). However, social order is constructed fundamentally based on emotions not rational processes (Collins 1981). Successful interaction rituals create emotional energy and a group membership feeling. Interaction ritual chains have the power to generate and increase the emotional resources of a group. This emotional energy act as a motivating force and through the repeated interaction rituals, it enhances institutional stability (Collins 1981, 2004). The work of Pentland (1993); Carrington and Catusus (2007); Guenin-Paracini et al. 2014 and Commerford et al., (2016) in audit research represents a focus on the emotional side

where auditors create comfort and is referred to in the literature as audit comfort framework (Commerford et al. 2016).

Pentland (1993) applied Collin's theory (1981) of interaction ritual chains and found that auditing as a ritual produces comfort, as a result of audit team members' interactions that transform the annual accounts of a company from an untrustworthy to trustworthy form that both auditors and the public are comfortable with. Carrington and Catusus (2007, page 36) described comfort as "*the relay baton passed between auditors in an assignment and between auditors and the actors in the capital market*". They adopted a classification scheme from nursing practice developed by Kolcaba and Kolcaba (1991). This scheme consists of three senses of comfort: relief sense involving the actions that produce comfort by relieving discomfort, state sense which represents an inventory of comforts and discomforts and renewal sense that involve new perceptions of acts that relieve discomfort.

Moreover, Commerford et al., (2016) examined the extent of real earnings management's impact on auditors' discomfort and identified how auditors use comfort building strategies to move from discomfort to comfort. They described a "Two-pronged" approach applied by auditors, using their audit rituals and procedures to build or re-establish comfort "rationality" and their body senses and emotions "gut feel" to identify risks. Similarly, Humphrey and Moizer (1990) found a similar finding related to the "gut feel" used in audit judgement when they analysed the audit planning process. Furthermore, Guenin-Paracini et al. (2014) found that auditors experience fear or discomfort as the "emotional experience of risk" at the start of the audit and strive to alleviate that discomfort via their procedures to reach comfort to give an audit opinion.

Following Pentland (1993); Carrington and Catusus (2007); Guenin-Paracini et al. (2014) and Commerford et al., (2016) application of the audit comfort framework, the researcher used it

as the theoretical lens to analyse the auditors' interview data in terms of how they describe their experience in producing the EAR.

According to Collins (1981, page 988):

"Sociological concepts can only be made fully empirical by grounding them in a sample of the typical micro-events that make them up"

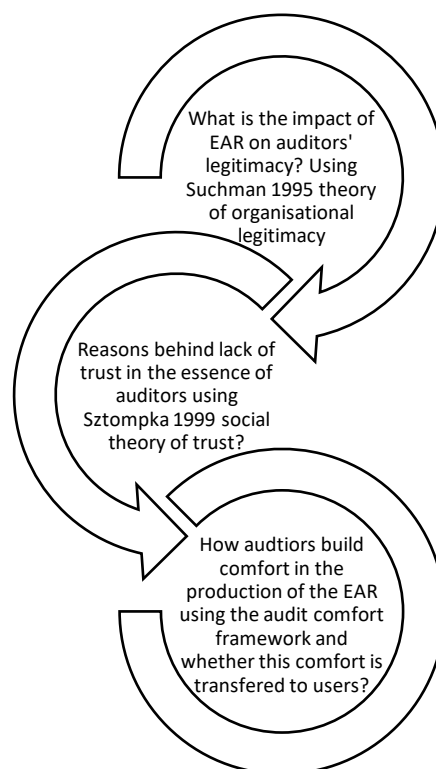
Applying Collin's argument to auditing and the production of EAR, I argue that in order to understand the process of production of EAR as experienced by the audit engagement team members, we need to break down the macro level phenomenon of producing the EAR as a legitimization tool to produce comfort, into micro level experiences of the engagement team auditors. This will help to unpack the meanings of comfort and credibility as articulated by auditors in the interview data. Pentland (1993, page 611) argues that the audit report *"constitutes the paradigm example of comfort as a commodity."* Consequently, I argue that the EAR serves as an audit ritual (Power 1999; Pentland 1993) to produce and convey comfort and trust to different users of the audit function. Furthermore, it provides a symbolic purpose of showing the process behind arriving at an audit opinion, which act as a tool to propagate procedural legitimacy (Suchman 1995). Looking at the EAR as an audit ritual helps us understand how auditors attach meaning to their work and how it produces and exchanges comfort and trust within the engagement team of auditors, within the audit firm and ultimately to the users of the EAR. It will highlight the social construction of comfort and trust in the EAR and the quality of audit work by the auditors (Armstrong 1991). Or as expressed by Pentland (1993, page 607):

"The reason for invoking the concept of ritual as an analytical device is to examine the deeper, more ambiguous levels of meaning associated with the work" where *"The analysis of rituals*

is always a question of interpretation, where the job of the analyst is to unpack carefully the layers of meaning which may be present.”

4.6 Summary:

I started this research with the main research question about the effectiveness of the EAR in restoring auditors' legitimacy using Suchman's 1995 theory of Organisational legitimacy to obtain an in-depth analysis of what types of legitimacy did the EAR succeed in restoring. It became clear during the interviews that although the EAR is viewed as restoring legitimacy to auditors' actions there was a bigger issue with the trustworthiness of the auditors themselves which required a further in-depth analysis of the sources of trust using Sztompka 1999 social theory of trust to inform the analysis of the reasons behind this lack of trust in the second research question. And to complete the understanding of the whole picture of the EAR, an analysis of the auditors' side of the story as preparers of the EAR was needed via the theoretical lens of the audit comfort framework to understand how auditors create comfort in the production of the EAR and whether this comfort is transferred to the users via the EAR.



Chapter 5: Research Methodology and Methods

5.1 Research Philosophy:

According to Laughlin (1995, page 65): “*All empirical research is partial and incomplete and that theoretical and methodological choices are inevitably made whether appreciated or not.*”

Hence, it is useful to start by clarifying my ontological assumptions regarding the nature of reality and epistemological assumption regarding what constitutes acceptable knowledge, in order to discipline the study in terms of methods.

I am using an interpretivist paradigm (Burrell and Morgan 1979; Chua 1986), as my lens to view the world, and it guides my assumption about the nature of reality (ontology) and how knowledge about this reality can be obtained (epistemology).

I am following a relativist ontology, where I believe that there are multiple realities that are created through individuals’ experiences. Where different people can experience the same event differently. To understand these multiple realities the individual experiences, need to be understood and interpreted by talking to the people who experience these realities and are experts of their own experiences. Hence, an emic interpretivist epistemology is most suited to understand the meanings individuals attach to their experiences of reality and how it is socially constructed. (Chua 1986; Burrell and Morgan 2016; Saunders et al. 2016)

In the context of the EAR, the interpretivist paradigm helps to get an in-depth understanding of the status quo of EAR as an existing regulation, as experienced by the users and the preparers of the EAR. Burrell and Morgan (1979) model of research paradigms (see figure 5.1) highlights how reality is viewed whether objectively as an objective reality or subjectively based on the subjective interpretation of the observer on the two sides of the x-axis. Furthermore, the y-axis shows the sociology of regulation on one side where the world is viewed as being relatively stable and can be studied as the status quo and the sociology of radical change on the other side

of the spectrum, where the world is viewed as a place that should be changed (Burrell and Morgan 2016). The interpretivist paradigm is particularly useful in the context of mixed findings of the archival academic research, different theories and puzzles that were identified in the literature review and theoretical framework chapters. As I am following a relativist ontology, I do not believe that reality is objective and is waiting to be discovered as in the functionalist research conducted on the EAR, reality is based on the shared subjective perceptions of the individuals engaged with the EAR whether as users or preparers of the EAR. As the EAR is already implemented, and my research questions are addressing its impact as an existing regulation or the status quo, hence the interpretivist paradigm is most suited to my research and research questions.

Furthermore, as Humphrey (2008) and Power and Gendron (2015) contend, this type of qualitative research is well suited to study complex expert practices like auditing.

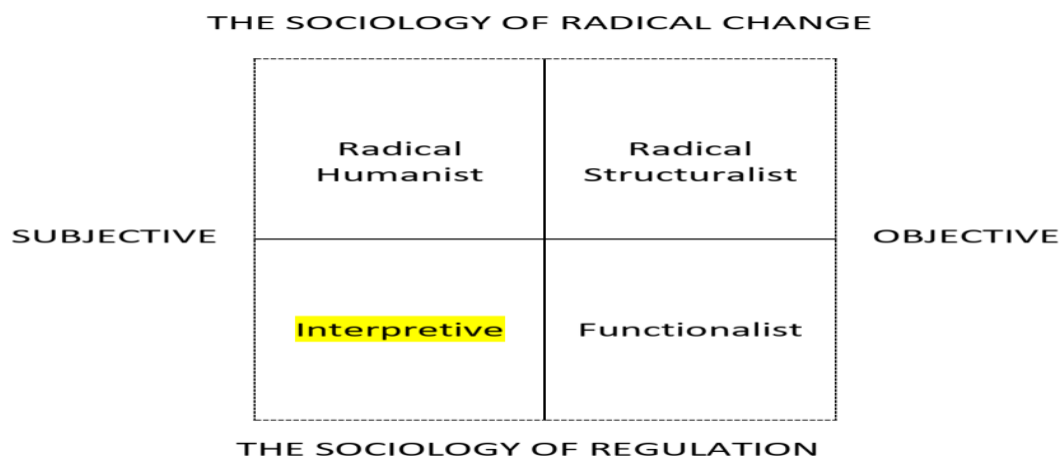


Figure 5.1 adapted from Burrell and Morgan 2016 page 22

5.2 Research Approach:

Given the mixed findings and competing theories explained in chapter 1 and chapter 3, it is hard to decide which theory to use in a pure deductive approach. As in a deductive approach there is more emphasis on the theory, and it represents the starting point. Furthermore, following a pure inductive approach which has more emphasis on the data will not be suitable. This is due to the limited number of observations due to the high costs of interviews and its limited number. Hence, it will not be enough to build up a grounded theory and generalize it (Bryman and Bell 2015; Saunders 2016).

The abductive approach serves as a middle ground between the deductive and inductive approach and overcomes their limitations, as it strikes a balance between deductive and inductive approaches. The abductive approach moves back and forth between the data and the theories, which allows the researcher to make sense of the data and obtain an in-depth understanding (Saunders 2016). It involves having different iterations between multiple theoretical explanations and how they apply to the field observations combining the use of the elements of deduction and induction (Modell 2017). As Blaikie's (2009, page 156) explains:

“Data and theoretical ideas are played off against one another in a developmental process. Regularities that are discovered in the course of the research will stimulate the researcher to ask questions and look for answers. The data will then be reinterpreted in light of emerging theoretical ideas, and this may lead to further questioning, the entertainment of tentative hypotheses and a search for answers.”

Hence, in order to answer the research questions for the research methodology, I follow an abductive reasoning approach (Lukka & Modell 2010; Mantere & Ketokivi 2013; Bryman & Bell 2015 and Saunders et al. 2016), which is particularly useful in light of the mixed findings “puzzles” of the prior research. Based on the collected data, I chose the best explanation of the

observations from the existing theories. The abduction helps to provide “thick explanations” by skilfully developing theoretical explanations using all the available theoretical and empirical data (Lukka and Modell 2010). In my research on the usefulness of the EAR, I started with a theoretical explanation from the literature based on agency theory which I changed completely after engaging with the empirical data from the interviewed users and auditors who provided rich insights that made me go back and look for theoretical explanations beyond the one initially identified. This iterative process was facilitated by the flexibility of the abductive reasoning that allowed me to arrive at the best interpretation for my data.

5.3 Research Method:

The most suitable data collection method given the interpretivist paradigm, and abductive research approach was interviews. Interviews represent an appropriate tool in qualitative research, which help to address the research questions. There are three types of interviews: Structured, Semi-Structured and Unstructured interviews (Saunders et al. 2016).

On one extreme, structured interviews are not suited for qualitative research as it involves closed questions that is more rigid and does not allow for follow up questions by the researcher to obtain the depth and richness needed in the data, as it is more suited to a positivist quantitative research. Unstructured interviews on the other extreme are more flexible with open questions but there is no control by the researcher on the direction of the interview. These are more suited to explanatory studies without predefined research questions. Semi-structured interviews offer a middle ground between the two extremes, as it provides an opportunity for flexibility and rich data collection as well as some structure to maintain focus on the research questions and help with data analysis by comparing the participants answers to similar questions (Bryman & Bell 2015; Saunders et al. 2016 and Silverman 2017).

Semi-structured interviews were chosen as the data collection method, as they help the researcher to be more responsive to the answers obtained from the users and auditors while addressing the research questions, by asking follow-up questions. Another benefit of using semi-structured interviews is that it provides flexibility and an opportunity to learn new explanations that were not identified in the literature. As argued by Malsch and Salterio (2016, page 6) interviews allow the researcher:

“to tap into the knowledge of those who have the requisite experience, first-hand knowledge, and understanding to provide meaningful insight into the issue being investigated.”

Moreover, given the abductive approach of the research, there is an overlap between the data collection and data analysis, which benefits from the flexibility offered by semi-structured interviews as it allows for new follow up questions based on the findings from the initial interviews (Saunders et al. 2016).

Conducting semi-structured interviews with users of the EAR as well as the preparers of the EAR (auditors) allowed me to obtain an in-depth understanding of the effectiveness of the EAR and capture the primary users and preparers experiences. This method, helped to overcome the major limitations of the UK archival research identified in chapter 3 in terms of the inability to separate the audit report from the annual report as both are published at the same time. Another benefit of using semi-structured interviews is that it helps to explain why the EAR is successful or unsuccessful in restoring legitimacy for auditors by using follow up questions to clarify the reasons behind the users’ perspectives. Similarly, it allowed the researcher to obtain an in-depth understanding of how auditors produce the EARs. Finally, consolidating the users’ reflections with the auditors’ reflections on the EAR’s impact helped to address the impact of the EAR on the information gap component of the audit expectations gap. Eventually, the richness of the data of the interpretivist research allows the researcher to obtain depth not breadth. Subjectivity

is highlighted as a hallmark of qualitative research (Braun and Clarke 2022) and theoretical (analytical) generalisability (Power and Gendron 2015) from conducting this research can be extended as highlighted in chapter 8, section 8.7 areas for future research. This contrasts with positivist archival research discussed in chapter 3, which emphasizes objectivity and empirical (statistical) generalisability. In the context of the EAR, the research findings from the empirical chapters 6 and 7 show the failure of the agency theory assumption about the average behaviour of a rational economic agent to provide a holistic understanding of the impact of the EAR.

5.4 Data collection:

5.4.1 Research Population and Sample (Users)

In order to address the first research question, primary interview data needed to be collected from the users of the EAR. The term users is very broad and involves a big diverse group of stakeholders (investors, creditors, trade unions, governments, regulators, the society... etc.). Given the limitation on the number of interviews that can be conducted and some unsuccessful attempts to arrange access with other stakeholder groups, I followed the conceptual framework of financial reporting (IASB 2018) in focusing on the primary users as current and potential investors (or shareholders) who invest in UK listed companies that are subject to the EAR standard. This represents the research population relating to the first research question. The researcher acknowledges, this selection as one of the research limitations discussed in Chapter 8 and provide an opportunity for future research to capture the views of the other equally important users of the EAR. As Young (2006, p. 581), warns that the standard setters' definition of users as rational economic agents risks replacing "flesh and blood users" with "hypothetical users". This focus on decision usefulness crowds out the moral accountability of businesses where poor working conditions can be justified based on cost reductions.

Convenience non-probabilistic sampling technique, followed by snowball sampling was used by the researcher. The reason behind these sampling techniques, is to make sure that knowledgeable participants are recruited and to overcome interview access obstacles (Bryman and Bell 2015).

A total of 16 interviews (detailed in table 5.1) ranging from 35 to 70 minutes with users was conducted online via video-conferencing services zoom and google meet and face to face and all the users were happy for an audio recording of the interview.

5.4.2 Research Population and Sample (Auditors)

In order to address the second research question, primary interview data needed to be collected from the preparers of the EAR (auditors).

Convenience non-probabilistic sampling technique, followed by snowball sampling was used by the researcher.

A total of 15 interviews (detailed in table 5.2) ranging from 35 to 70 minutes with auditors was conducted online via video-conferencing services zoom and google meet where all the auditors except for 2 participants, were happy for an audio recording of the interview. In these two interviews, the researcher took extensive notes during the interview.

Table 5.1 Interview Participant details (Users)

Interviewee Code	Interviewee Role
USR 1	Senior Manager – M&A Consultancy
USR 2	Investment Banker
USR 3	Senior Project Manager
USR 4	Partner – M&A Consultancy
USR 5	Finance Director
USR 6	Manager – M&A Consultancy
USR 7	Investment Banker
USR 8	Individual Investor
USR 9	Individual Investor
USR 10	Financial Manager
USR 11	Senior Manager – M&A Consultancy
USR 12	Private Equity Financial Analyst
USR 13	Individual Investor
USR 14	Individual Investor
USR 15	Senior Financial Analyst
USR 16	Portfolio Analyst

Table 5.2 Interview Participant details (Auditors)

Interviewee Code	Interviewee Role
AUD 1	Assistant Audit Manager – Big 4
AUD 2	Senior Audit Manager – Big 4
AUD 3	Audit Senior – Big 4
AUD 4	Assistant Audit Manager – Non Big 4
AUD 5	Assistant Audit Manager – Non Big 4
AUD 6	Director – Big 4
AUD 7	Audit Senior – Big 4
AUD 8	Director – Non Big 4/ Senior Audit Manager – Big 4
AUD 9	Audit Manager – Big 4
AUD 10	Senior Audit Manager – Big 4/ Non Big 4
AUD 11	Senior Audit Manager – Big 4
AUD 12	Senior Audit Manager – Big 4
AUD 13	Audit Senior – Big 4
AUD 14	Audit Senior – Big 4
AUD 15	Assistant Audit Manager – Big 4

5.4.3 Securing access to the interviews

The data collection took place after COVID 19 pandemic so the majority of the 31 interviews were conducted online from February 2021 until September 2022. The researcher initiated contact with potential participants by sending an email invitation including the participant information sheet and the consent form (see appendix 1). Interview questions were not sent before the interview to the participants, as the researcher is interested in their spontaneous reactions and responses. Some participants wanted to see the interview questions beforehand, which was not a problem, but a health warning was given, as it is a semi-structured interview so not all the questions are necessarily going to be asked and more questions based on the participants responses are going to be expected (see appendix 3 for the generic semi-structured interview questions included in the interview schedule). The researcher made sure to plan ahead properly for the interview to collect the best possible data, including highlighting the importance of the participants contributions to inform the analysis, ensuring ethical integrity, anonymity and confidentiality of participants, establishing rapport with the participants and being a good listener (Bryman and Bell 2015; Saunders et al. 2016).

As Robson (2002, p.377), contends “*real world research is the art of possible*”. The researcher relied on his personal networks initially from his experience as an auditor in a Big 4 firm, alumni networks of London School of Economics and Chevening Scholars for practitioners working in auditing and financial sectors in the UK. This proved to be of great help, as email invitations to potential participants without prior knowledge did not prove to be successful. For some participants it took several months and, in some cases, almost a year from their acceptance of participation in the interview to conducting the actual interviews. This was primarily attributed to their busy schedules and the challenges posed by the pandemic for e.g. working from home while looking after their children. Hence, persistence and tenacity were very import for the researcher to secure access. As planned interviews were rescheduled

multiple times due to sudden work commitments but appreciating the busy nature of the practitioners and sensibly following up ensured achieving the required access.

As for the sample size for both users and auditors, following Malsch and Salterio (2016), more interviews are not necessarily better, as the goal is to keep interviewing up to the point where there is no additional insights obtained or “data saturation” is achieved. In other words, until the required richness of data was achieved to enable an in-depth understanding of the participants experiences.

5.5 Data Analysis:

Thematic analysis was used to analyse the interview data of the users and auditors. As Reflexive Thematic Analysis (RTA) is a “theoretically flexible method” (Braun and Clarke 2022). It allows for identification of patterns and themes within a rich dataset. It is about the complexities, contradictions and nuances in a rich dataset rather than a simple answer. RTA coupled with the flexibility in the abductive research approach within an interpretivist research paradigm, allowed multiple iterations between different theoretical explanations and the empirical data allowing the formation and reformation of themes until the best possible explanation was reached. The researcher listened to the interview recordings multiple times and transcribed all the interview data while adding reflexive notes to ensure accurate transcription and deep engagement with the data. This was done as soon as practically possible after each interview to enable the constant reflection and back and forth between the theory and data so it can inform the subsequent interviews. After the transcription of all the interviews was completed, the transcripts were systematically analysed to generate codes and candidate themes, which kept changing along the data analysis phase until the final themes were identified and analysed in relationship to the best theoretical explanations the researcher arrived as a result of the abduction process.

The researcher started initially by examining the agency theory perspective as adopted by the regulators and extant archival literature on the EAR. Based on the users' interview data, the EAR's failed to achieve its intended impact despite providing much more information to users compared to the prior one-page audit report. Factors outside the agency theory framework led the researcher to look for a deeper analysis using Suchman's (1995) theory of organisational legitimacy and its analytical typologies. As shown in chapter 6, the deeper analysis showed that the EAR was successful in achieving legitimacy for auditors' actions as doing the right things while failing to achieve legitimacy for the auditors' essence as being the right social actor for the job. Themes and sub themes explaining the reasons behind this failure emerged from the data analysis due to the lack of users' trust in auditors as social actors. In particular independence, competence and accountability of auditors were identified as the sub themes behind this lack of trust. The researcher went back to the theories to find the best theoretical lens to analyse these themes. Sztopka (1999) sociological theory of trust and its sources was the best theoretical lens to make sense of the interview data and complement Suchman's (1995) theory to address the first and second research questions. The theme of comfort creation through the production of the EAR informed the researcher to utilise the audit comfort framework (Pentland (1993); Carrington and Catusus (2007); and Guenin-Paracini et al. (2014)) as the theoretical lens to analyse the auditors interview data as explained in chapter 7. The theme of the challenges of the production of EAR emerged and was broken down into four sub themes relating to summarising the audit effort in one report, audit fees pressure, time pressure and litigation risk.

5.6 Ethical considerations:

The researcher was very careful in considering the ethical issues related to the research to ensure informed consent and no harm to the research participants (Bryman and Bell 2015; Saunders et al. 2016). The researcher attended the ethical training provided by the university to help identify any potential issues. Moreover, the researcher carefully followed the University of Sheffield's robust process for ethical and data protection aspects when collecting primary research data that involves human participants. The ethics application was submitted, and an approval was obtained from the university ethics committee before the collection of any interview data. Consent forms and participant information sheets were prepared by the researcher and emailed to the participants before the interviews took place and were signed and emailed back to the researcher. They contained information about the research and its purpose, and stressed the voluntary nature of participation, data protection and confidentiality. The design of the semi-structured interview questions did not contain any sensitive or offending materials and there was a low risk of ethical issues. Participants were still advised that they can stop the recording at any point and refrain from answering any questions they are not comfortable with which did not happen at any of the interviews. Data protection under GDPR, anonymity of the participants and confidentiality of data were followed throughout the research process. Participant were given codes with no names, or any identifying information disclosed.

Chapter 6: Analysis of Users' Interview Data

6.1 Introduction:

This chapter presents the views of investors as users of the Extended Audit Report (EAR) as explained in Chapter 5, where Reflexive Thematic Analysis (RTA) (Braun and Clark 2022) was used to analyse the interview data of the users. The interviewees' views helped in addressing the first (RQ1) and second (RQ2) research questions:

- RQ1: Did the EAR succeed in repairing Auditor's legitimacy?
- RQ2: Do users trust the information in the EAR?

The themes presented and discussed below have emerged from the interview data from the users' narratives. These narratives showed commonality and agreement among the interviewees.

- Theme 1: The Role of EAR in establishing legitimacy in auditors' actions.
- Theme 2: The reasons behind the failure of EAR in establishing legitimacy in the auditors' essence.
 - Sub Theme 2.1: Users lack of trust in auditors' Independence.
 - Sub Theme 2.2: Users lack of trust in auditors' Accountability.
 - Sub Theme 2.3: Users lack of trust in auditors' Competence.

The rest of the chapter is structured as follows: section 6.2 analyses theme 1, the role of EAR in establishing legitimacy in auditors' actions. Section 6.3 analyses theme 2, the reasons behind the failure of EAR in establishing legitimacy in the auditors' essence. Section 6.4 provides a summary of the findings and how they address the research questions.

6.2 Theme 1: The Role of EAR in establishing legitimacy in auditors' actions:

All users in the interviews agreed that Auditing is very important even more after the increasing complexities of business and big accounting scandals and the financial crisis. Example quotes are shown below:

“To add credibility to the financial statements that someone else has prepared. So, without their audit opinion, how would you know that those financial statements have been produced in the way they should be? An audit report would give you some sort of comfort that the financial information you are looking at is credible. So, I suppose I can't imagine a world where you don't have auditors, because how could you rely on the management to produce the statements in a way that's not affected by bias or whatever?” USR08.

“One of the reasons why you become more reliant upon auditors and auditors' reports is because perhaps the accounting regulations are becoming more and more complex. For example, it'd be a lot easier to kind of verify and understand a set of accounts that's just been done purely on a cash basis, whereas clearly, you've got your accruals basis, you've got all your IFRS regulations around fair value accounting, et cetera, et cetera. That becomes quite complex for an outsider to verify the accuracy and authenticity. So, I think that the reliance and importance of auditors is certainly growing. You can see that in some of the regulatory developments as well that the government put in place in terms of audit turnover and stuff like that” USR15.

“Audit work is really important, for e.g. no bank would let you raise funds without audited financials from a well-known registered auditor, without it they will kick you out” USR02.

Similarly, USR01 confirms the importance of audit: *“definitely, the role of the auditor is extremely useful.”* And even the users who have concerns about the effectiveness of the audit process agree that we cannot do away with auditing, as it is very important, but a lot can be done to improve its effectiveness:

“So, auditing I think would be something very important, especially like after financial crisis and then people have a lot of doubt on the system we have for the companies. I think auditor should play a quite important role here. I think it is very important but is it working properly is another issue” USR13.

The introduction of the EAR as a legitimating tool succeeded in giving legitimacy to the auditors' actions. Building upon the theoretical lens of Suchman's (1995) theory and his typology of organisational legitimacy and its analytical types discussed in Chapter 4, the users' responses and narratives indicated that the EAR succeeded in achieving procedural moral legitimacy. Procedural moral legitimacy influences the actions of the auditors in a continual basis. As the EAR opened the black box of auditing by detailing the KAM's, how materiality levels are arrived at, the responses to KAM's and how the audit scope was adjusted given the KAM's and materiality levels. Shedding a light on the audit procedures black box in the EAR give the auditor procedural legitimacy as science like methods that represent socially accepted procedures of calculating materiality and identifying and addressing KAM's. Procedural moral legitimacy as Suchman's (1995) contends becomes particularly important when the outputs are invisible or inherently difficult to measure. In the case of financial statements audit, it is not clearly visible the outcome of audits where no fraud cases are discovered and what constitutes a successful and high audit quality is difficult to measure and depends on the evaluator's socially constructed definition of success (Power 1999).

Consequently, the EAR secured the understandability (comprehensibility) of the cognitive legitimacy by making the audit process more understandable to users through the auditors' disclosures on how the audit was conducted. As USR03 explained:

*“the EAR gives you a lot of understanding to the user how the audit is performed, which was before like this is a black box, so the auditors are engaged, they perform their audit and they give you the final report, but now we have more clarity how that was designed and conducted and performed and if you looked at the key audit matters, you would understand what made the auditor conclude his opinion on the financials overall. So again, before none, none of this was disclosed. So now this is very transparent process bringing this extra improvement”*USR03.

This view was also shared by other users:

“So, I think with the current revisions you mentioned and the expansion of the auditor's report and disclosing the key audit matters and materiality and how the auditor and what was the auditor's methodology for calculating the materiality? How they performed their scope and how they tackled some of the key issues. It is a really positive improvement and I think it has contributed to a more comprehensive and more useful audit report” USR01.

Even the more sceptical users, also contend that more information is not necessarily better in all cases but still welcome the extension of the audit report.

“More is not necessarily always better, you know, in that sense. But I still think it's better to have more than too little. I mean, at least you have then the information at hand that you can scrutinise than if you have not it documented” USR06.

Furthermore, users rely on the assurance from new KAM's and materiality in making their investment decisions. This achieves pragmatic exchange legitimacy for the actions of the auditors as the EAR helps users by providing new information that was not include in the prior

standardised on page audit reports. This information help users in their decision-making process. As USR07 explains:

“Before I invest in a company, I want to see what kind of risks I may, you know, have in investing in that company, right? So that is why I look in the audit report what risks (KAM’s) of this company that is listed there right, and I see if I can live with that risk because I think as an investor, the first or as a fundamental investor, the first thing is do not lose money. And you do not lose money in, you know, managing really the risk and return profile basically. One advantage of the EAR is that they have an extended version of discussions between the auditor and the company, right. So, I can see, OK, what questions were asked, OK, what was the problem and I can really dive into it deep and can understand a few things” USR07.

Similarly, USR02, USR15, USR03 and USR01 made a similar argument:

“Informing investors about things they do not know about it is extremely important” USR02

“Just from an investor's point of view, if you don't have the independent auditors, I think what you would end up doing is not investing simply because any organization can cook the books and do whatever. You could get into a position where if I don't trust them, I'm not going to invest. So, I think there has to be that level of trust with the company and the auditor in order to make those decisions” USR15.

“It is really hard to ask the right question, we need to get the information now, have more relevant information so they give more insights to the user, how the audit was designed and planned and how did they cover, for instance, risk areas that the auditor have identified, so this is really a very good value added to the audit report, I would say” USR03.

“It helps me if the auditor is flagging some areas where there is a specific concern, or if they are mentioning issues and what procedures they have performed to tackle these issues? It gives me a good starting point when performing the financial due diligence so that I can see from

the auditor perspective where the challenging areas are? And that could help me in designing my scope of work and customising it. Depending on the areas I'm looking at and be able to prioritise, when I'm performing my work, so it's definitely useful” USR01.

Even when the information in the EAR is not necessarily new, users still find it useful as USR 15, USR02 and USR16 explain:

“I think what it is, I would not say it is new new information. I would say it is more validating either the information in annual reports and accounts or kind of what we understood. So that validation provides additional reassurance that the risk disclosures of the business and the risk as an investor, we believe that company faces are on the right line. So, I'd say from my point of view, it's more validation rather than mind blowing new information” USR15.

“Yes, absolutely. The riskier here, the company is. That will affect the discount rate that we use in our valuation, and this will bring the value of the company down. It (KAM) is either clear something or confirms something that is already out there” USR02.

“First of all, that conflict of interest is obviously there. But then the problem is what is the alternative source? This is the best we have. It's necessary” USR16.

This provides more insight to the study done by Lennox et al. (2022) and Gutierrez et al. (2018) that even if the information in the EAR and KAMs are not new and were known to the users beforehand they still need assurance from auditors to validate the credibility of the information.

The above findings support the agency theory perspective adopted by Reid et al. (2015), that the EAR reduces the information asymmetry between the users (investors as principal) and the company managers (as agents) which results in more informative and useful audit reports. It also addresses the users' information needs for additional disclosures by the auditors in the audit report identified prior to the issuance of the EAR (Church et al. 2008; Coram et al. 2011; Vanstraelen et al. 2012; Mock et al. 2013; and Simnett and Huggins 2014) and after the

issuance of the EAR in the FRC and government reviews (FRC 2015;2016; 2022 and YouGov 2014; 2016). However, as identified in chapter 4, there are factors beyond the traditional agency theory framework that affects the users' assessment of the usefulness of the EAR. As agency theory only consider managerial accountability and does not factor public, professional and personal accountability (Gray et al. 2019). Hence it provides more insights relating to by Lennox et al. (2022) and Gutierrez et al. (2018) archival studies who found the UK EAR uninformative to users. As the users' interview findings highlight that it is not just a question of EAR containing new information but also more fundamentally whether users trust this information and the auditors who provide such information and if not why?

Furthermore, given the research ontological and epistemological stances an in-depth understanding of the shared subjective users' experiences and views is needed. This will complement our understanding of the archival studies which rely on the positivist objective reality assumption regarding users as rational utility maximising economic agents adopted by the agency theory. Users' interview data analysed in the next sections shows while the EAR succeeded in establishing legitimacy for auditors' actions it failed to secure legitimacy for the essence of the audit function itself. As users, have serious doubts about the independence, competence and the accountability of auditors which waters down the usefulness and trustworthiness of the audit process and its visible output the EAR.

6.3 Theme 2: The reasons behind the failure of EAR in establishing legitimacy in the auditors' essence:

All the interviewees welcomed the extension of the audit report as improving the legitimacy of the auditors' actions as what would Suchman (1995) describe as desirable, proper and appropriate and as *the right thing to do*. However, based on the interviewees' narratives the EAR failed to secure legitimacy for auditors themselves as being desirable, proper and appropriate. The users agreed that the current institutional setting of auditing *is not the right organisation for the job* and auditors are not the right social actor for the job. Hence, the EAR failed to achieve the dispositional pragmatic legitimacy, the moral structural and personal legitimacy as well as the cognitive taken for grantedness legitimacy.

As discussed in chapter 4, Sztompka (1999) social theory of trust and its sources is used as a theoretical lens to make sense of the findings from the interview data. The EAR as an abstract object of trust involves a set of complex trust relationships. Trusting the EAR implies more than trusting a report, it relates to trusting individual auditor who prepare it, the accounting firm where they work, the regulators who oversee their work and the auditing profession as a whole. As the reasons identified by users for this failure all relates to their lack of trust in auditors' independence, competence and accountability. Hence, these reasons are grouped and analysed into the following three sub themes: users' lack of trust in auditors' independence, users' lack of trust in auditors' competence and users' lack of trust in auditors' accountability.

6.3.1 Sub Theme 2.1: Users lack of trust in auditors' Independence

The most common theme that emerged from all my users' interviews was their doubts about auditors' independence. Auditor independence is the cornerstone of the audit theory and practice. It has been identified in the auditing literature as a primary concept and fundamental postulate of the auditing theory and practice (Mautz and Sharaf 1961; Flint 1988). To ensure that all the participants share the same concept of auditors' independence, I checked that they agreed with DeAngelo (1981) definition of Audit Independence as the probability of auditors reporting a breach in the auditees' financial statements. The users had serious doubts about auditors' independence starting with how auditors are hired and compensated, provision of non-audit services and eventually audit tenure.

Hiring of Auditors and fee dependence on auditees:

Based on Sztompka (1999) classification for the sources of trust, one of the primary sources of trustworthiness is appearance. As indicated below by users, the current structure of how auditors are hired and paid completely lacks the appearance of independence. Even with the current corporate governance efforts to aid the independence of external auditors, users do not trust auditors' independence. The hiring of external auditors is done by the audit committee members of the board of directors on behalf of the shareholders (which is formed of independent non-executive members), users do not trust that this process improve independence due to the risk of board interlocks (Chiu et al. 2013). Furthermore, another primary source of trustworthiness relates to reputation, which is also heavily impaired by the accounting scandals and issues with board interlocks that emerged after these scandals (Coffee 2006; Sikka 2009; Gray et al. 2019; FT 2022 and FT 2023d). Presented below are examples of users' quotes that support this argument:

“The independence of auditors. That's where I have the least faith. It is very difficult to bite the hand that feeds you. It's a structural problem of how auditors are appointed and paid. If you look the way the firms consider an audit fee as an annuity payment almost in perpetuity. So how many businesses can put at risk an annuity that pays around 100 million dollars a year. So that's difficult from a business perspective. So that I think is the biggest, how shall I put it? Personally, I think that is the biggest structural challenge in people having more faith in audit” USR04.

“Auditor role is to be independent. I believe it is not there. Independency and the reason I think again my views must follow is clear because again we have these organisations who are recruiting these external auditors, not only recruiting. I think what is most important is paying their wages. And if you take the big four like with Carillion, they are paying millions to the auditors. I think it was KPMG with them. And the auditors, obviously they're not going to say no to them, they're going to say yes, we're going to sign off the audit report because they don't want to lose a huge client. They say that auditors are appointed by shareholders, and which I do not believe is true. It is just there in context. In corporate governance, I do not believe that holds true because it is the directors that actually tell the shareholders. Look, this is our selection and the shareholders, because they are scattered around the world, they will just approve” USR14.

“You can never be 100% independent while you get paid no matter about anything else. So even if you are 100% independent in every other respect, you're not entirely because they are paying you for your service” USR08.

“To be independent, trustworthy must be non-profit or has to reduce the conflict of interest. Right. Then making it a non-profit organization or maybe just separate business from the consulting. The exchange has the company securities listed on. They may take a lot of money

from there. Maybe they are responsible to pay for it. Yeah, it just needs to be paid differently”
USR16.

“I think, if at some point if the auditor back to the point about the auditor getting paid by the company. If, let's say another body, let's say the Stock Exchange for example, appoints the auditor that that could be a very good step. And yeah, it. It could lead to; you know to more independence for the audit team.” USR01

“One of the key challenges is that the auditor gets paid by the company that they are auditing right? So, that's kind of, you know, means that the external auditor cannot be 100% independent when it's getting paid by the entity that there are auditing” USR01

“Everyone thinks that auditors are independent, but sometimes in their interactions with management while they are negotiating their fees they are not. I have seen auditors negotiating their fees with their clients and when the client did not like the fees, they fired the auditors”
USR02.

These findings are consistent with Dart (2011) questionnaire-based study of UK investors after the financial crisis and famous accounting scandals, who perceived the auditor’s economic dependence on the auditee as a threat to auditor independence.

Alternatively, USR03 and USR08 made an argument that auditors are usually taking more blame than they should on their reputation for independence as good audits do not receive media attention and there is no clear statistics on what are the percent of bad audits/good audits to the total audits performed:

“I would say that those cases will keep coming (accounting scandals), that's inevitable. But we cannot generalise the process. So, one bad apple will not spoil the rest and I look into different industry looking at plane crash. I will make an analogy here that this is very highly professional field where there is plenty of control and there is a lot of automation, even

though from time to time things happen and there is a human to be blamed behind and that human could be the pilot and it could be the auditor. So, I wouldn't generalise that one bad auditor or one bad accountant would ruin the rest of the auditor reputation individual cases about doctors, practitioners, about engineers, about a pilot, about an auditor will remain as a human. Good examples do not need media coverage” USR03.

“It's a funny one, isn't it? Because indirectly, what might increase your trust about it would be to hear about all the audits that actually carried out. Well, there is no problem. And that is perfectly well. You only ever hear about the bad apples, and if that's all you hear, people general perception, trust in them plummet something, perhaps. But equally, there'll be loads of audits going on that are done or whatever, and without this kind of total number of good audits, and then you compare it to the bad ones, no percentages, it's yeah, I have no idea. I have no idea about the entire audit market. How many audits have done in a year? I have no idea” USR08.

So, on balance, users agree that auditor independence is a major concern that reduces their trust on the quality of audit work, however there might be a negative reputational bias as only the negative cases get wide media attention. So, this ties back with Sztompka (1999) primary sources of trust in relation to reputation and performance which both negatively impact users trust regarding auditors' independence. Reputation is strained by the accounting scandals and performance which is not really visible in case of good audits or what is the definition of good audits. Furthermore, interviewed users are not aware of the percentage of good audits versus bad audits as it seems that FRC's need to create more awareness of their yearly audit inspection reports.

Provision of Non-Audit Services:

The auditing literature had mixed findings regarding the impact of providing non-audit services such as consultancy and tax advisory services by the audit firms to their audit clients. Francis (2006) reviewed 40 years of research on non-audit services and found no “smoking gun” evidence linking non-audit services to audit failures. However, it negatively affects the auditors’ appearance of independence. Dart (2011) found that the provision of non-audit services represents a greater threat to auditor independence as perceived by UK investors. This finding supports Mautz and Sharaf (1961) argument, that the only way to maintain independence in appearance for auditors is to provide auditing services without any provision of non-audit services. Alternatively, Ashbaugh et al. (2003) found no systematic evidence that auditors impair their independence when providing non-audit services. The interview finding support the argument that non-audit services impair auditors’ independence. Example quotes from the interviewed users are presented below:

“Audit work is not very profitable compared to some of the consultancy. You look at your M and A consultancy or fundraising consultancy that you could get with some of the big banks or IT consultancy, that's where they make the predominant amount of the money” USR15.

“The fees for consulting are very high, right. You pay their various fees from I don't know 1,100 to up to 5,000, right a day which is gigantic in comparison to audit fees, but the audit project is of course a very long-term project. It's always kind of a, you know, indirect conflict I would say” USR06.

“It's not just the audit fee. It's a tax fee that is just as big as the audit. Previously it was the consulting fees which were just as big as the audit fees. That's the biggest problem if you ask me, the audit profession in my view, having seen it from inside and outside” USR04.

“I can see that independence is impaired by auditors getting engaged in some other non-audit activities, and it's commonly happening. You may be aware of the audit and Assurance policy of the UK that might be relevant to the recommendations came from the policy. There are some recommendations, but actually it's not even up to stakeholders' expectations. I expect more than those recommendations too, and I expect the implementation part. We need to see those implemented and we need to be clear about independence, because independence is important for objectivity. Independence is a reporting line. However, objectivity is a mind-set. So, we need to have both in place to make sure that any auditor is really objective, speaking freely, is sharing any bad news, regardless of any consequences” USR11.

The findings confirm and supports the regulatory decisions to prohibit the provision of non-audit services (Kingman 2018; CMA 2019; Brydon 2019). Even after the regulation prohibiting the provision of non-audit services to publicly listed audit clients, users still doubt the actual implementation of this separation. A manger in one of the big 4 consultancy department highlighted the issue:

“We have numerous internal control systems on that in order to avoid a conflict of interest, but you see, there is always a way. I am not saying fraudulently circumvent this, this is not the case, but. I mean there is a clear Chinese wall between audit clients and clients we can service with consultancy. But there is always an internal anticipation to the business one day becoming a consulting service potential client, right? So, there you may then want to leverage existing contacts, and this gets a bit wishy washy, you know” USR06.

This was confirmed by a senior manager in a big 4 during the auditors' interviews, that despite the consultancy and deals division has been separated from audit into two separate legal entities with different domains, they still share the same building. Similarly, other users also still have their doubts as USR15 contends:

“I thought that there needs to be complete organization separation. I mean it's like you have these Chinese walls. My experience is Chinese walls are kind of see-through and not soundproof walls. So, from that point of view there is this especially in a Deloitte and a PwC (a big 4). These are private organizations owned by the partners. Their goal is to maximize the value of the business. So, there is definitely a conflict there” USR15.

All in all, users find audit firms' incentive structure, the way they are hired and the fact that audit fees are much lower than non-audit fees significantly impair the appearance of auditors as independent objective third party. Audit fees represent a recurring cost for businesses that they are constantly trying to reduce whereas non-audit services are one offs that are much more profitable to audit firms, who are viewed by users as a for profit partnerships.

Audit Tenure:

Another aspect that users identified as problematic when it comes to their trust in auditors' independence is the very long audit tenure that inevitably impairs auditors' independence. The argument is that they become too familiar with the auditees and lose their professional skepticism. As accountancy theorist Shyam Sunder contends, the interaction between the auditor and the auditee looks like an interaction between a fashion photographer and a model. *“The photographer records not simply the appearance of the model as it is in fact, but actively engages with the model to produce images that serve the purposes of both”* (FT 2018).

Similarly, USR04 expresses a similar concern:

“I have gone through crisis in my time in my career where there have been audit failures. And uh, I have seen that happen. And it wasn't intentional, it was the proximity to the client that causes these problems, right. It is not that anybody is trying to or was trying to cover up fraud, but you lose what is called professional scepticism. You are no longer sceptical. The challenge we have always seen is that if there is a stricter and what we would say a more correct

interpretation and a one that's more favourable to the client, they will always go for the more favourable interpretation for the client. And that, I think, it inherently comes from the independence issue.”

Similarly, USR09 and USR08 explain:

“Well, I think I started with a very naive idea that auditors, external auditors are the perfect control that we should have. And that was 15 years ago. And after, I think, 17 years of being in the market, I think we have lost almost completely the control function of the audit. The external auditors have become more of an adviser rather than control” USR09.

“Equally you can't do an audit without talking to the management and trying to understand what's going on. Therefore, you end up building a bit of a rapport” USR08.

Even after the implementation of the mandatory audit partner rotation and mandatory audit firm rotation, users want the rotation to be for the whole engagement team, not just the senior engagement partner. They also would like the audit firm rotation to happen more frequently.

As USR14, USR06 and USR12:

“If the audit partner has rotated, the audit team is the same. They don't get rotated because if you bring a new team in, you've got to make sure they experienced. Then you have the issue of training again.” USR14

“I would like a higher auditor rotation” USR06

“I would like to see audit firm rotation more often to be every 2 to 3 years” USR12

Users valued more audit rotation to have a fresh eye and more independent, sceptical auditor. These findings support Carey and Simnett (2006) research where longer audit tenure was associated with lower audit quality. Conversely, Dart (2011) found that UK investors are less concerned with auditor rotation compared to auditors' economic dependence on the clients and

the provision of non-audit services. Similarly, in Australia Kaplan and Mauldin (2008) did not find a significant difference between rotating and keeping auditors in their experiment on MBA students. The participants valued the presence of a strong audit committee than rotating auditors. Ruiz-Barbadillo et al. (2009), did not find an improvement in independence (using the likelihood to issue going concern opinions as proxy for independence) as a result of mandatory auditor rotation in Spain. Furthermore, Cameran et al. (2015) did not support mandatory auditor rotation as they did not find an improvement in audit quality, and this was attributed to the loss of the in-depth knowledge of the auditee without any corresponding benefit in audit quality. The limitation of the above studies is that they use different proxies for independence that does not capture the appearance of independence for the users of the audit services. So, all the users from the interviews recommend more audit firm rotation, however they acknowledge that it would not be easy to achieve given the oligopolistic nature of the audit market, where the big 4 dominate the majority of audits of publicly listed companies. This had its own impact on their level of trust in the accountability of auditors that is going to be addressed in the next section as USR04 explains:

“If you think of an audit firm and let's look at it as a business. An audit engagement. I know we have rotation and everything, but it is so you rotate amongst the familiar few. You can't get a smaller size firm (non-big 4) to audit HSBC. That is never going to happen. It is just not going to happen. Simply because they just do not have the expertise or the scale to do it”
USR04.

This quote materialised in practise, a year after this interview was conducted. HSBC had to tender its audit contract and ended up retaining PwC as their auditor for another 10 years (FT2023).

6.3.2 Sub Theme 2.2: Users lack of trust in auditors' Accountability

Sztompka (1999) argues that Secondary sources of trustworthiness include Accountability of trustees and the context and situations in which the trust relationship exists. In the context of Auditing, the regulatory oversight by regulators like the FRC in the UK and the PCAOB in the US, who audit the auditors and review their audit reports and compare it to the working papers in their audit files plays a critical role in the EAR trustworthiness. Furthermore, the market context where auditors operate influences the users' trust in the accountability of auditors. The findings from the interviews involved two main concerns: the oligopolistic supply side of audit services and the ineffective regulatory environment.

Big 4 market concentration

The lack of competition and the oligopolistic nature of the audit market in countries dominated by the big 4 auditors, results in lower audit quality and creates significant entry barriers to the big listed clients (Gunn et al. 2019). The FTSE 100, the FTSE 350 and listed companies in major stock exchanges are dominated by big 4 as their auditors (Sikka 2022). This makes the big 4 too big to fail and the regulators unable to afford another Arthur Anderson. Given the prohibition of non-audit services and the rules of competition and the big entry barriers to non-big 4, in terms of resources, investments in data analytics, economies of scale, talent acquisition and retention it means that the options available are very limited. As USR02 and USR04 explain:

“Too big to fail, I always hear about this by few if you're following the news, every year the Big four get fined millions and millions, and they are still getting new leads, new clients and life is good. So, I feel like when I read these news, I feel like, yeah, this is just to show the public that we're doing our work, we're watching these guys and these guys are under our

scope, but ultimately that's not what's happening. And people in the market know that. We cannot afford another Arthur Andersen” USR02.

“For example, again in financial services, one of the things that's happened is that the firms have become too big to fail. No regulator, God forbid, for any reason can bring down one of the big Four. Who's going to audit the large banks? And if you look at these firms, they're not small anymore, they're massive. They dominate it, not just the FTSE 100. They are one of the largest recruiters of new graduates in the UK. They are one of the best paymasters. They are also having the skill sets in them to do the things which they have done. So, they have become giants” USR04.

As a result, auditors have the incentive to collude together and produce standardized generic uninformative boilerplate risk disclosures (Mimetic Isomorphism) to reduce their litigation risks and please their auditees (DiMaggio and Powell 1983; Coffee 2006; Lennox et al. 2022). This would lead to reduction in audit quality and reduce the motives for continuous improvement. So USR13 and USR02 recommended having a ranking for audit firms based on audit quality instead of revenues and number of clients:

“There should be somehow like quality rankings (for audit firms) to increase in the competition in the industry. I think it's very somehow more helpful rather than just this big four audit companies who dominated majority of the big firms” USR13

“Regulators, they need concrete criteria on how they evaluate the auditors who are active in the market and maybe one thing could be like based on this criteria they can rank the auditors. Because auditors, you know the way they are ranked in the market, they are either ranked on terms of revenue generated or in terms of number of offices or in terms of number of employees, which has nothing to do with whether these answers are providing good quality

or not right? So maybe one solution for that to just publish a report maybe this would be some sort of a pressure on the auditor, a non-big four can compete on quality” USR02.

Furthermore, due to lack of competition on audit quality, according to Institutional theory, coercive isomorphism (DiMaggio and Powell 1983) might be the response of auditors as a result of the new audit reporting standard mandated by the FRC to gain legitimacy, regain public confidence and maintain their reputational capital. This might lead to a “Label Adoption” where auditors just conform to the letter of standard rather than its spirit, resulting in symbolic boilerplate auditor disclosures. This could be explained by the process of “decoupling” where the formal structure does not conform to the actual practice. (Meyer and Rowan 1977; Power 2003 and Baker et al. 2014).

Ineffective regulatory environment

Users agreed with the Brydon (2019) and the Kingman (2018) reports that the current regulatory environment is not fit for purpose.

“My answer will be specific to UK regulatory process. There is no bite, no teeth that regulators have. I think auditors are the ones who get away very lightly every time. And there have been a few cases recently where they have been fine. The latest one was the Greensill being one of the examples. But it's too little, too less. And the culture of audit is not going to be affected by those deterrence. Regulation is definitely not fit for purpose. Especially the bankruptcy laws and how it is being used to avoid all the liabilities to all those vulnerable stakeholders as they put them towards employees or even small suppliers and everyone. It is horrible. And it's happening again and again and again and there's no deterrence” USR09.

“Regulatory capture is also a big issue.” USR04.

“They know each other, FRC whenever they may they look at improvements or they are communicating with these audit partners” USR14.

“It has to do also with those who are working at these (audit) companies and their network. There were a few partners three or four partners that got fired from one of the Big Four, I think it was KPMG and these guys were working before at PCAOB, then joined KPMG. They had friends working at PCAOB and they knew which clients are going to be inspected and ultimately, they tried to fix the working papers before the inspection. It went public and these guys got fired and they got sued” USR02.

“I like the approach of comply or explain. It gives enough flexibility to businesses, to auditors, of course, with flexibility comes the opportunity to dress the window and put it that way, or to that elbow room to move around. The idea is that the regulation should take care of that. That if there is a wilful misrepresentation, that should be taken care of by the regulators. But the regulators failed to do that. And that is why this flexibility that was given for efficiency is now being used for simply collusion and misrepresentation” USR09.

Furthermore, users highlighted that regulations are usually reactive instead of proactive, especially with the rapid developments in Fin-Tech and increasing complexities of businesses.

“Regulators are more reactive rather than being proactive” USR02.

“I think all the regulation is behind, actually, the business practice that people always can find a way to avoid or try to get away to. Regulation, especially finance that develop very fast. We have Fintech, I think this specialist kind of things every day something innovation or everything new is coming. This is a problem we might face, especially the financial market, financial innovation and new technology. And you combine technology with the finance I think it's never ever seen before.” USR13.

Given the arguments above, with the increasing complexities of businesses and developments in Fintech, users have trust issues in the current competence and skill set of auditors that is discussed in the next section.

6.3.3 Sub Theme 2.3: Users lack of trust in auditors' Competence

As indicated in the previous section, the rapid development in the Fintech and the increasing complexities of business has led users to doubt whether auditors have the right skillset to address and audit these complex transactions. USR09 and USR03 explain:

“The audit function is always not one, but two steps behind the market in terms of valuing those complex financial assets. The internationalization has also thrown another challenge to it, valuing assets across different continents, through different, quite complex financial structures. But that is what auditors are expected to do. We cannot go and say that it's complex, so they cannot do it. They do train for it” USR09

“Auditors need to be more technically competent on the industry to be able to audit the industry. Industry is evolving significantly and auditors understanding, and perception should match. And why does it matter? Because the auditor would have to understand the process and the industry to ask the right question. If you don't really know, you will ask the typical question, which doesn't bring the information that the auditor want.” USR03

This is exacerbated if the audit firm is a non-big 4, according to USR04 and USR15:

“If it is a mid to small size firm, other than the big four, my level of trust is limited because they just don't have the capacity to have the experts in House”.

“It's such a tricky problem to overcome as well, because if you start branching downwards and downwards into some of the smaller audit companies, it actually raises a further question of the competence of some of these smaller companies who are not used to auditing such big organizations” USR15.

Furthermore, the structure and levels of seniority in audit teams is another aspect that reduced the users' trust in the auditors' competence as explained by USR14, USR15 and USR02:

“They are trainees training up to be auditors, so we've got what happens. The auditors like KPMG, the Big Four they are sending in these trainees to do the audit of these big complex organisations which I do not believe that it should be happening. It should be more qualified, more auditors, more Industry experts in. Industry experts, not trainees. You could see the cause that's where you're getting these loopholes, the gaps, the problems, the issues” USR14.

“My experience of having auditors in when I worked in ... For example, what we actually saw was the auditors were typically graduates. So, you saw kind of 22, 23 year old people and you had a senior auditor that was maybe kind of 25, 26 and then kind of the audit lead. What I would like to see is that those undertaking audits perhaps kind of there's a bigger pool of more senior auditors and those with more experience. These liabilities on the derivative side of things that are calculated using quite complex math, I'm fairly confident the vast majority of auditors will not have that expertise to understand how that number has been calculated. And especially some of the off-balance sheet kind of exposures; they might not even understand where those exposures are actually even being created from” USR15.

“The partners or directors already have a lot of experience, and they interfere during the audit process. But I think one problem is usually the juniors or the ones who are interacting with clients on daily basis, they don't have that much expertise to handle such situation of such complex transactions (financial instruments) for instance. Lack of time for training especially for complex transactions like crypto currencies and leaving the training on the job” USR02.

These findings agree with the Brydon review (2019) recommendation of including in the EAR a breakdown of number of hours spent in the audit engagement by seniority of staff.

Eventually, the high turnover in the audit industry makes users doubt whether auditors have an in-depth understanding of the industry as USR10 and USR03 argue:

“Because of that turnover, high turnover, that means the experience and knowledge you have in one set of team that obviously isn't consistent. Yeah. So, then you're losing a lot of experience and then that means you'll have to do another refresher or there might not be that same sort of experience that you had before. There's a lot of knowledge gaps” USR10.

“The general feeling and what I have really seen that they (auditors) are more into the figures than the business. So sometimes, they lack the in-depth knowledge about the business which is really crucial if you want to see that if these financials are correct and how the information flow or you judge the performance of the entity. So, you really need to understand the industry where you perform. So, I would expect an auditor in pharmaceutical is totally different from airliner from communication from oil and gas. So, you can't send the same team to perform different audit, but they need to have all an in-depth knowledge in every industry. So that's really crucial and there is a big room for improvement there”

USR03.

6.4 Summary of findings

The analysis of the users' interview data helped me to address the first and the second research questions using the theoretical lens of Suchman (1995) and Sztompka (1999).

RQ1: Did the EAR succeed in repairing Auditor's legitimacy?

The introduction of the EAR as a new technology to restore legitimacy for auditors succeeded in restoring legitimacy to the actions of auditors but failed to secure legitimacy to the essence of auditors themselves. Users appreciate the new information about KAM's, materiality levels as doing the right thing. It helped to secure pragmatic (exchange), moral (procedural) and cognitive (understandability) legitimacy.

The EAR failed to achieve the pragmatic (dispositional), moral (structural and personal) and cognitive (taken for grantedness). Auditors are not seen as the right social actors for the job.

RQ2: Do users trust the information in the EAR?

Users do not trust the information in the EAR. The reasons behind this, stem from users lack of trust (primary sources of appearance, present and past performance as well as secondary sources of accountability and context of trust relationship) in the independence, accountability and competence of auditors and the audit process.

All in all, the analysis of findings of the users' interviews showed that despite the improvement in the EAR as the only visible communication channel having more information than the previous audit reports, the users still have an issue with the source of the information which is the auditor preparing the EAR. So, it is not just about the trustworthiness of the information, it is also about the trustworthiness of the source of information. That's where the in-depth analysis of the findings led to the ways in which the interviewed users believe the trustworthiness of auditors can be improved. Thus, the argument becomes that understanding and addressing these wider issues with auditors' independence, competence and accountability

in the context of the EAR will improve the trustworthiness of auditors' themselves as the source of information leading to an improvement in the trustworthiness and effectiveness of the EAR as the communication channel of this information.

Chapter 7: Analysis of Auditors' Interview Data

7.1 Introduction:

This chapter presents the views of auditors as preparers of the Extended Audit Report (EAR) as explained in Chapter 5, where Reflexive Thematic Analysis (RTA) (Braun and Clarke 2022) was used to analyse the interview data of the auditors. The interviewees' views helped in addressing the third research question (RQ3):

- **RQ3: What is the auditor's experience of implementing the EAR? What are their reflections on the concerns raised by users?**

The themes presented and discussed below have emerged from the interview data from the auditors' narratives. These narratives showed commonality and agreement among the interviewees.

- Theme 1: The Production of Comfort through the EAR as a symbol of comfort.
- Theme 2: The Challenges in preparing the EAR.
 - Sub Theme 2.1: Summarising the audit effort in a one report.
 - Sub Theme 2.2: Audit fees.
 - Sub Theme 2.3: Time pressure.
 - Sub Theme 2.4: Litigation Risk.
- Theme 3: Auditors' reflection on the concerns raised by users.
 - Sub Theme 3.1: Users lack of trust in auditors' Independence.
 - Sub Theme 3.2: Users lack of trust in auditors' Accountability.
 - Sub Theme 3.3: Users lack of trust in auditors' Competence.

The rest of the chapter is structured as follows: section 7.2 analyses theme 1, the production of comfort through the EAR as a symbol of comfort. Section 7.3 analyses theme 2, the challenges in preparing the EAR. Section 7.4 analyses theme 3, auditors' reflection on the concerns raised by users. Section 7.5 provides a summary of the findings and how they address the research question.

7.2 Theme 1: The Production of Comfort through the EAR as a symbol of comfort:

During the interviews with the auditors all the interviewed auditors agreed that the primary role of external auditors is to give comfort to the financial statements and annual accounts users.

As explained by AUD04:

“In my opinion, I think an external auditor's role is to give comfort to the user of the account. So, it is the responsibility of management to prepare the account statement of account. But as an auditor, it is our duty to give our opinion as to the true and fair view of the accounts so that the user of the account can get the comfort that the statement has been prepared in true and fair, there's no material misstatement.”

Similarly, AUD14: *“So mainly it's just to give comfort to the users of the financial statements, that the financial statements are true and fair.”*

But before auditors can give comfort to the users, they themselves need to be comfortable with the annual accounts and the financial statements to be able to transfer their comfort to the users.

As AUD01 explains:

“We look for appropriate evidence, we need to be comfortable over the audit evidence in order to support our opinion.”

Once they become comfortable, they transfer their comfort to annual accounts and financial statements users through an unqualified audit report which represents a symbol of comfort (Power 1999). Alternatively, if they do not feel comfortable, they won't be able to issue their opinion in the audit report as explained by AUD08 in one of the engagements he/she was in:

“We had a meeting with the audit committee, and we talked to them why we couldn't issue because we were not comfortable to issue an audit opinion”.

Guenin-Paracini et al. (2014) found that auditors experience fear or discomfort as the “emotional experience of risk” at the start of the audit and strive to alleviate that discomfort via their procedures to reach comfort to give an audit opinion. Similarly, analysing auditors’ interview data shows that auditors use the EAR’s KAMs, materiality levels as an audit ritual (Pentland 1993) to build and transfer their comfort with the opinion reached. To reach this opinion auditors use comfort building strategies from the audit procedures conducted in the planning and fieldwork stages.

This was evident from the interview data where auditors were describing their experience in the preparation of the EAR. I present below quotes from the interviewed auditors that describe the process of the preparation of the EAR along with the audit procedures and comfort building strategies employed by the auditors:

“Whenever we start an audit, whenever we are planning for an audit, we do a report which is called a planning report or an Audit Strategy Memorandum (ASM). We do that which shows, okay, these are our key risk areas, and these are our plan, procedures to address those risks. Then at the end of the audit, we do what we call a Summary Review Memorandum (an SRM) that lists basically all the risks and the procedures that we have done and the results of those procedures” AUD15.

“Those significant risk areas are areas that we pay particular attention on. We understand the process. We do like a walk through to understand the process, the controls and everything. We do massive testing we call it SCOT plus (Significant Class Of Transaction), meaning the sample instead of normal transaction that we’re testing or normal area that we’re testing, that will probably give us a sample of, let’s say, 20, this could give us a sample of let us say 300” AUD05.

“KAMs are usually areas of misstatement, areas with high effect or material effect on the financial statement if something wrong in this area. And to take the decision to present this as

a key audit matter in the audit report. It is long process and discussion between the Engagement partner and another discussion between Quality Review partner of the file (audit file). And then we have something called the Risk panel. Risk panel include the Engagement partner and the Quality Review partner and another Risk Management partner of the department to discuss all these matters and then conclude what will be presented as a significant audit matter” AUD11.

“The planning materiality, when it is mentioned, it is more now, I would say it is more now transparent. What was really important for the auditors, what is exactly the thresholds? And we do, by the way, agree with the or discuss, I would say the planning materiality with the audit committee on the planning phase, because we do have more than one meeting as a minimum, I would say, for the listed company, we should be having like a planning meeting with our audit committee. This is before we start our fieldwork, we get some preliminary data from the client, we do some meeting with the management or the CFO before having this formal audit committee meetings. We scan the financials. We go through the RNSs (Regulatory News Service), all the announcements, we go through all the updates. We understand the business. We go through the major contracts’ agreement, and then we draft our planning materiality, which is really one of the major this is the major threshold that we use when setting up our risks, when this is the threshold we use when calculating our sampling. So, again, this is really very useful just to let the users know and imagine how did the auditors do the sampling, approach audits, what was actually the major or the significant accounts that the auditors had looked at during his fieldwork” AUD10.

These findings agree with, Commerford et al., (2016) who utilised the auditor comfort framework to examine the extent of real earnings management’s impact on auditors’ discomfort and identified how auditors use comfort building strategies to move from

discomfort to comfort. They described a “Two-pronged” approach applied by auditors, using their audit rituals and procedures to build or re-establish comfort “rationality” and their body senses and emotions “gut feel” to identify risks. Taken together auditors establish comfort and convey it to users in the form of a clean audit report.

“We go through all the presented figures in the annual report, and we get evidence and support to it in our audit file. But we cannot take the full responsibility to say like this is 100% correct. We provide reasonable assurance and from our testing and our audit file as an area of improvement the risk management team as a practical example the risk management team improves the audit procedures in relation to this area. When we say something in the financial statement, when we say something in the audit report so internally, we know that up to high certainty it is correct because something like to assess the going concern and we have to assess the going concern for at least twelve months from the approval of the financial statements, which is fine, something reasonable. But also, to overcome this you have the viability statement scenario, which is required for the listed company. And Viability statement scenario it's discussing the financial performance of the group over the next three years under worst case scenario. So, our role is to challenge management to see, and we perform some stress testing to assess if this is reasonable or not. And in addition to the assumptions provided by management, we add more assumptions to take it down, to challenge the revenue, to challenge the profit, to challenge all the Capital Expenditures (CAPEX) in worst case scenario, just to assess the impact. So, I feel we're providing a reasonable assurance, which because we cannot say it is absolute assurance, high degree of assurance I can say. We discuss our other procedures in relation to fraud and how we cover the risk of fraud and how we cover the management override of controls. And we have to present a summary of completed procedures and our conclusion. In addition, also like the other area of how we covered non-compliance with those under regulation and providing a summary of laws under regulations that have

direct effect on the financial statements and what other laws and regulations have an indirect effect to the business” AUD11.

A similar comfort building procedure was also used by AUD10:

“One of the partners I have recently worked with one of the clients who was acting as a second review partners on one of our listed clients apart from the engagement team, apart from the engagement partner, we should have a second partner reviewing independently the conclusions and the audit file. So he mentioned a very useful tip just to avoid this kind of situation, he is also insisting that whenever there is a KAM mentioned in our audit report, we should link, we should have one separate working paper linking this KAM to the audit file just to make sure that the conclusions in our audit for matches with the KAM and we didn't miss any item that should be in a KAM or shouldn't be in the KAM section.”

As discussed in chapter 4, the auditor comfort framework developed by Pentland (1993), Carrington and Catasus (2007), and Guenin-Paracini et al. (2014) is used as the theoretical lens to make sense of the findings from the interview data.

Auditors have always conducted their audit procedures to achieve the relief sense of comfort. By doing so, they create a state of comfort and move from the discomfort feeling associated with the risk of failing to detect material misstatements and arrive at the incorrect audit opinion when they produce and publish their audit opinion in the audit report which is regarded as the symbol of comfort.

For example, as AUD08 explains:

“I used to audit newly established companies that haven't been audited before. And the risk here is not what's been recorded, it's what hasn't been recorded in a situation like this. Because those new companies, there are a lot of transaction happening in the background, and they

don't have a good team to account for these things. So, you always worry about what's not being booked, not what's been booked. And there are a lot going on. And I was trying to tell them, okay, guys, here's what I need. Go work on it. And they provide me with what I need. And then I go back again with questions. And then we reach to a point. Okay, guys, just keep that in mind. What would you do if you were in my shoes? Would you just let it go? I need your honest opinion. Like, if you were the auditor, what would you do? You would just let it go or you would just keep pushing until you get what you need in order for you to feel comfortable with the numbers. This is where you need to balance between, they feel that you are on their side, you are being reasonable with your request, you get the request to them timely. So, nothing as a surprise, if the due date got pushed, it gets pushed. Yeah, it's a process."

Similarly, AUD11 explains why he had to question the qualifications of an expert hired by the auditee to value a complex transaction so he/she can become comfortable to rely on the expert's work:

"I had a call with expert within the company and I started to ask him about his objectivity and his qualifications because I am relying on his report. So, I have to assess his qualification, like if maybe he's a member of any organizations, he has a license, something like that. So, I have to assess all the provided information. And also, for our testing, we rely on external evidence, not only the information provided internally."

The application of the EAR and the introduction of KAMs and auditor response to them made this more visible to different financial statement users (comfort seekers) which raised the bar even higher compared to just the audit file and the audit findings report to the audit committee. Furthermore, the persistence of the expectation gap (Humphrey et al. 1992; Porter 1993; McEnroe and Martens 2001; Lin and Chen 2004 Dixon et al. 2006; Porter et al. 2012 and Ruhnke and Schmidt 2014) and the corporate accounting scandals (Sikka 2009; FT 2022 and

FT2023d) have raised the bar even further. Hence auditors need to achieve the renewal sense of comfort. As AUD10 explains:

“In terms of audit procedures, I would say that there is no difference. It should be the same before or after (the EAR). But in terms of how do you present these kind of KAMs and the language used and the conclusion reached, I would say, as a minimum for a new client, new listed client. As a minimum, we, the (audit) firms will be involving the technical teams in reviewing the draft of these audit reports before they get published because those technical members more experienced and act as a back-up for ourselves. Not just a second partner review, but a technical team member, senior technician team member, his eyes would be very useful on those reports. That's only the difference. And again, sometimes when they see the draft and go through the audit reports, they raise really very important questions. They don't go deeply on the audit points as the second partner, engagement partner, but they raise some very challenging questions specifically in the KAMs.”

Therefore, auditors build comfort through audit team members' interactions at the micro level with the auditee personnel, the audit committee, within the engagement team of auditors, within the audit firm and ultimately to the users of the EAR at the macro level. To this point, Carrington and Catusus (2007, page 36), described comfort as *“the relay baton passed between auditors in an assignment and between auditors and the actors in the capital market”*.

Near the competition of the audit engagement auditors reach the *state sense of comfort* which represents an inventory of comforts and discomforts (Carrington and Catusus 2007). Then the auditors decide after the stocktake of comforts and discomforts on whether the auditee receive a clean audit report or not. And as Commerford et al., (2016, page 41) contend: *“achieving auditor comfort is not a binary setting, but rather a continuum, where the auditor may employ comfort-seeking strategies to move closer to the comfort end of the continuum.”*

All the interviewed auditors agreed that the introduction of EAR is a step in the right direction as explained by AUD02:

“I think the previous report was very binary, so you had to know what one unqualified report means. And I remember having conversations with clients who had nothing to do with sort of Auditing background and said just like in plain English qualified sounds better to me why we're talking about unqualified, which I think highlights the language barrier. I think the extended report has just made it more accessible to people to understand what is that the result of the audit is where did you spend your time as an auditor and what is the perspective? Materiality just gives perspective of how and what extent were you looking at the risk of misstatements?”

Similarly, AUD12 agrees:

“I think that does give the user of the financial statements more insight about the risk of the company and it also helps shareholders and investors just to understand the risks of the company because not everybody can understand the risk of a company like an auditor can. So it just adds more insight to the financial statements, I think, which can only help the user of the financial statements”

And AUD01 also explains:

“It explains more about the risks, the procedures, even the materiality, so that information that was not written before, wasn't disclosed before. So that make it more informative to the user. What we are doing, what risks did we identify and what did we do about them”

However, the production of the EAR has its challenges and concerns that auditors raised during the interviews which I present in the next section.

7.3 Theme 2: The Challenges in preparing the EAR:

Analysis of the interview data identified four main challenges in the preparation of the EAR: summarising the audit effort in one report, audit fees, time pressure and litigation costs. These challenges are analysed in the following subthemes.

7.3.1 Sub Theme 2.1: Summarising the audit effort in one report

Auditors have expressed their concern of the trade-off they face when deciding how much information to include in the EAR. As AUD02 and AUD 12 explain:

“I think the challenge is how to tell the story without being cluttering and just making sure that when you are identifying, for example, the significant risks, what are they telling? It's difficult to say, this is the risk that I identified and this is what I did. Because you probably did a lot more other things. And so, I think reaching that balance between telling the most meaningful information without becoming a very lengthy and unhelpful information. But I think the short answer that for me would be balancing between providing information that is meaningful but also not cluttering.” AUD02

“The thing is how much information? It's not like you're putting every single procedure in there. You need to strike a balance of writing too much and not writing enough to it but giving me enough relevant information.” AUD12

They all agreed that the audit file is much more comprehensive than the audit report and it includes much more information and details about the audit work and the audit effort:

“The audit process is very big. It's not that can be summarized in a few lines or a couple of pages. The audit process is very long, like when you say risk assessment. There are a lot of efforts behind this. We do an understanding of the process, of the client which could be massive in big companies and keep having discussions with the client, discussing with the team. We reassess again during the audit process. It doesn't end at some point. I see the audit report,

regardless of how much information you add, still wouldn't reflect the effort behind the audit that's being done. We still do more than it describes.” AUD01

“The audit file is not something you can summarize” AUD10

“The audit report now, even after presenting the key audit matters, this is a summarized paper”
AUD11

They have expressed that if they were to include all the relevant information in the EAR it might lead to unintended consequences. As AUD02 explains:

“There is a risk that the more you include, the less relevant it becomes because we already face that risk with the financial statements. Investors constantly tell us that we need less information that is more concise and less boilerplate. So, I think I don't necessarily think having more in the audit report is going to be helpful. I think it's more constantly challenging whether what you're telling is the most important information you should be telling.”

Similarly, AUD14, AUD12 and AUD05 contend:

“You don't want to have massive book where people have the financial statements with hundreds and hundreds of pages.” AUD14.

“I think you run the risk of putting in too much information that people won't read.” AUD12.

“You do not want to bore the readers; you don't want to put all issues there. Because they are not reading newspaper, they need to easily be able to see what we have done. It is just about capturing it. There are issues that we just feel there are not material, they don't need to go into the report. I think so, because like the one that I have with me as an example, it is twenty pages. Twenty pages! To me, it is too long to be fair, if I am not an auditor” AUD05.

These concerns agree with the findings from YouGov (2016) study where investors raised concerns in terms of the increased length and complexity that adds to the already bulky annual report which might reduce its usefulness.

So as a result, some auditors suggested to present the KAMs in a separate section in the annual report like the footnotes disclosures for example as AUD08 suggests:

“All the information included in the KAMs can be addressed in a section in the footnotes that says company’s risks. Differently. Differently said as an auditor, there are a lot of other things that is not riskier enough to be mentioned in the KAMs that I have done a lot of work on. But that does not mean I didn’t assess the risk. I didn’t involve our valuation team; I didn’t find errors. But there is nowhere to talk about this in the KAM. So, do we agree that those KAM are risks existed and the company actually admit that those exist? Yes, let’s agree on that. So, my point being, we audited the financial statements, including the footnote disclosures. It can be a footnote disclosure where the company talks about those risks and what they provided to the auditors in order to get them comfort around this. And when I audit those notes, I will say, yes, they actually did that. Do they need to be in the audit opinion? No. And the reason why? The audit opinion will get bigger and bigger and bigger by time, until you feel like you read thirty pages in order to decide yeah. Should I invest or not?”

And all the interviewed auditors agree that although it is good to focus on the audit report, but regulators should put more focus on audit quality as AUD10 explains:

“In my opinion, I wouldn’t say that the additional information or presentation from the auditor side would enhance the relationship or how do the public view the auditors. This would be enhanced by actually the quality of audit work that has been done by the engagement team, rather than that showing that we did blah blah blah yes, we definitely did this, but they would get more confidence that they would see less cases, less scandals less issues and problems, less

frauds. So, I would say I prefer that concentrating a high-quality audit file and services provided to the clients this would gain the confidence not only report maybe adding additional paragraphs to the audit report might be helpful again for the financial statement users. But that wouldn't be just that helpful if there is no proper documentation, a proper plan, a proper conclusion that have been rolling before issuing these announcements or the additional paragraphs.”

7.3.2 Sub Theme 2.2: Audit fees

All the interviewed auditors agreed that the EAR is an expensive document to produce and although the audit procedures and risks of material misstatements and materiality levels existed anyway before the introduction of the EAR in the audit file, having to report on it on the face of the EAR significantly increases their costs. As clearly highlighted by AUD12, AUD11, AUD06 and AUD01:

“For sure. They take a while to write. They're written by a kind of most senior levels of the team, and then they go get reviewed by the partner, then they get reviewed by Professional Practice Director (PPD), so they go through very senior levels of review. So, I mean, they are expensive documents to write, but rightly so, because ultimately that is the deliverable from the audit firm, what used to just be draft a kind of boilerplate report and put a signature on. It has now become something that's going to take a decent amount of time to draft and then it's going to go through a lot of levels of review before ever going to public domain. So cost is reasonably high. I think obviously the aim is to pass it all on to the client. Clients have their own agenda. No client will like this, paying extra for an audit report. Ultimately, yes, it does have to be passed on to clients, but clients are pressing us for fees” AUD12

“It cost us more work and more time needs to be spent. Also, this is reflected on the audit fee, which is already challenged by clients. We ask for more money and they push back most of the time. The challenges internally from the audit procedures, because we have extra work needs to be done in our audit file and we have specific usually when there are updates from FRC or International Standards on Auditing (ISA), usually the risk management team prepares a new template to make sure they cover all the requirements ISA updates. So, it's like additional working paper in our audit file and we should spend more time to cover, which is in fact, they are adding value to all the users, all the stakeholders of the financial statement” AUD11

“I hear new regulation or a new report section. It's not us, it's the regulator. This is something I need to go now and negotiate an additional fee for the company” AUD06

“Generally, I would say we are not doing additional procedures. We do the same procedures as we are doing before the additional things. We need to put this into a report. So, we look more into summarizing what we have done in clarifying our risks. Also to be in an audit report shape rather than working papers. So, there are kind of additional work, putting this into audit report. Also, what I see is we are assuming more responsibilities now, more risks. So, we are exposed to more risk as an auditor because of the wording, as you add more words, you are exposing yourself to additional risks or additional responsibilities. I'm not saying we are trying to get out of these responsibilities, but this may not be compensated enough from the client, which is always, or I wouldn't say always, the audit profession is one of the professions that I would say are undervalued. It's a very important one and it takes a lot of effort to be completed however, in general, I don't think the auditors are compensated well enough” AUD01.

All the interviewed auditors agreed that this push back on audit fees has its downsides and puts extra pressure on auditors as explained by AUD02:

“In my experience, it's very difficult to ensure that you are doing all the work necessary to satisfy the growing requirements coming from, like, the auditing standards, the local requirements, and I'm talking about laws and regulations that are specific to the jurisdiction. For example, I used to work for very big global banking audits, and you have budgets of millions, and you're still struggling a lot to keep within those budgets, because the entities we were auditing are growingly more complex and complex, and you need a lot of resources to do it. And so, I think the fees have to be reasonable enough so that the audit teams don't feel that pressure. I understand that there's always going to be a conflict between you really want for example, when we were implementing auditing the implementation of IFRS 9, it was really

difficult for us. All the specialists you need for those models that the banks were doing, but you needed them. Because otherwise, how can you be confident that the number those models are driving is actually reasonable and faithful reflection of what actually management expects in terms of credit losses? But at the same time, you need automated data analytics, and they all cost money. In my experience, for example, we were dealing with a first-year audit, which adds a pressure on costs”.

AUD08 summarised the main reason behind the constant pressure on audit fees by the auditees:

“The reason why the audit fees are much less than other services is because to companies, it's a fixed fee and they are all companies with no exception. They are trying to reduce their fixed fees and fixed cost. They think about other services or not, you come in, you do the service, you know, you go even if it's going to cost me a million dollars for an audit service that costs you a million dollars, that means a million dollars this year, a million dollars next year. So, when you put your ten year plan, you have to justify why, how are you going to pay the \$10 million over two years? So, it's a whole different mentality the way that companies think about the audit. That's why there is a lot of pushbacks on the audit fees year after year. Because they think about the long term and how they maintain that, think about it, that the company is going through turmoil and then all of a sudden, they have to let some people go, they can't let the audit go. So, the only thing that they can do is just to push for less fee. But for the consulting services, when you are implementing a new system or whatever else, it's a onetime thing. So, they are willing to pay more to get this over with” AUD08.

As discussed in chapter three, these findings do not support the archival research finding by Reid et al. (2019); Gutierrez et al. (2018); and Lennox et al. (2022) who contend that because the information is already available from auditor discussions with the audit committee and the new standard just made them public information it is not costly for auditors and hence do not

result in a significant increase in audit fees. And it supports the findings of Zhang and Shailer (2021), who found on average an increase in audit fees as more Risks of Material Misstatements (RMMs) or KAMs are included in the EAR. As AUD13 explains:

“When it was for the first time that this detailed audit report was in place, I think this was not considered while doing the budgeting and the resourcing and considering this to be a part of the fee structure. But now I think everyone factors this as well. So, it is not that the organizations are doing additional piece of work for free. Of course, they have already factored this in the budgeting that the audit report, the amount of procedures, additional procedures that we are doing to give a narrative on the performance and everything. So, I think it is already factored in the budgeting. So, I don't think that it's an additional piece of work without being compensated.”

7.3.3 Sub Theme 2.3: Time pressure

Another challenge identified by the interviewed auditors, is the increase in the time pressure after the introduction of the EAR. Time is already limited given the short window that auditors have to report on the annual performance and financial position for a whole year in just two months' time as AUD02 explains:

“Even, if you talk about those kinds of properly governed entities, then I would say I think the trouble for me was always timing. It's not so much that your management is not cooperating, it is the expectations are quite unrealistic in the sense that basically with the timelines we look at where most of the audit reports and annual reports also for a calendar year for December, we are talking about early February, which means so you can have the most cooperating management, but you cannot really get anything up to, say, mid-January. So, we are talking about two weeks' time for the audit guys to digest all the information they need. And so, I think I see that quite a big challenge.”

And adding the EAR and the process of its preparation that involves numerous interactions within the audit firm exacerbates the time pressure on auditors. This was evident in the interview data as shown below:

“Yeah, I think it is obviously because the report is so detailed and it is so time consuming that for the auditors, it is an additional piece of work and because the audit report is so detailed and the amount of disclosures have also increased. So, I think in terms of time, I would say it is more time consuming” AUD13.

“When you're on the ground, the audit manager is the one who kind of agrees the amount of hours that's available for the audit, and you kind of have to do it within those hours. You're always chasing the clock and you're always kind of trying to find efficiencies, because the

problem with it is it's an expense of the business and the manager wants to kind of get as many clients as possible” AUD07.

“The challenge, I would say, is to you have done like two months’ worth of work and you want to put it in a little report, you understand? Be able to capture everything that has happened in just a little report. That’s the challenge in there. Most people don’t know the time, and the effort that goes into preparing that report, because you still need to capture what you’ve done and to put that in a context that is readable and understandable, and we’re able to capture everything that’s happened, a lot of issues that happened, the effort to do that together” AUD05.

7.3.4 Sub Theme 2.4: Litigation risk

The final challenge identified by the auditors was the impact of the EAR on litigation risk. And here the interviewees were divided into two opinions: that the EAR it does not have any impact on the litigation risk or that the EAR increases auditor's litigation risk.

The argument for no impact is based on the idea that what really matters in courts in case of litigation against the auditors is the more comprehensive audit file not the EAR.

As AUD10 explains:

"I believe that it's not about what you have included in the audit report. I mean, the regulatory authorities is something in each audit firms picking up some files to review, making sure that these are complying with the rules and regulations. So even if there is a good, I would say presented audit report and the file is not that at the expected level, you will get in trouble. It's not about only what you announce to the public in terms of the auditor, what you want, what is included in audit report, rather than just what is behind this audit report. How did you reach these conclusions, what kind of evidence you did get, how did you scrutinize actually the independence of the evidence and the completeness of evidence you get. How did you rely on this, on this evidence and so on. I mean yes, it's our final product. I would say the audit report is our final product, but I would say our main product would be the audit file. It's your baby, you feed him whatever he wants to eat, and then it grows up with you until it gets mature, and you can present this to the public."

This was also reinforced by AUD12 and AUD11:

"It shouldn't have any impact on litigation." AUD12

"I don't think so. Okay, because usually the court challenge if we perform at our audit procedures according to the standard in the right way or not. But usually now most of the big four, now they have released all new templates and new standardized working papers to make sure that the audit team covered all the areas and covered all the procedures." AUD11

This viewpoint does not support the experimental work of Brasel et al. (2016) and Kachelmeier et al. (2017) who contend that KAMs offer litigation protection for auditors. As auditors believe that what matters in courts during the litigation is the whole audit file not the audit report.

Conversely, the argument for increased litigation risk, comes from the idea that now auditors report more in estimates and complex financial instruments that are inherently uncertain and thus making these visible in the EAR would increase litigation exposure for auditors after the widespread accounting scandals. As users would start to ask and question with hindsight why did you not do this procedure or include this risk:

“There is a huge litigation risk. Some people will come in and say, okay, I need to know all the journal entries that have been waived on. Well, you're telling what your materiality is and how you calculate it. Now I need to know what did you waive on just to make sure that you didn't waive on something that could be material to me. Yeah. So, the next step is going to be, okay, let's now publish what is the uncorrected misstatement. And the uncorrected misstatement, that's a whole other can of worm because it depends on, one firm will require a consultation for large uncorrected misstatements, another firm does not require it. Who's right and who's wrong. It's judgmental.” AUD08

“For the user, it's better information for the users. However, for the auditor, I consider it more risky for the auditor, I don't see. For the audit, from the auditor point of view, I see. No, the auditor is assuming more risk. However, this wouldn't be compensated well enough.” AUD01

“Things that happened in the UK around 2017, 2018, just highlighted one more time to me how there are so many people who you would expect to know what it is supposed, the audit report is supposed to tell them and more importantly, what it is not. They still don't know what it is not like. And I don't I'm talking about oh, do they go there and look for fraud? To me, that's the question they're asking. They're asking what is that you didn't do? And I don't think if I start

telling what I didn't do, I don't know what I would end. Yeah, but I think it's just continuously being mindful what is the information needed out there? And if at some point we need to say we didn't do this, then maybe we should" AUD02

This perspective agrees with the results of the experimental work that was conducted in the US prior to the introduction of CAMs (the US equivalent of KAMs), where Backof et al. (2022) found the disclosure of critical audit matters increases jurors' negligence assessment of auditors under Litigation Costs Hypothesis. Furthermore, it agrees with the YouGov (2014 and 2016) study, where concerns were voiced by auditors about increased liability for audit firms as a result of the increased disclosures arguing that auditors have unlimited liability which make the auditors think twice before disclosing information.

Eventually after considering the auditors' side of things in terms of their experience in the production of the EAR and its challenges. We cannot get the full picture of the value of the audit report in general and the EAR in particular as a symbol of comfort without the users' assessment of the independence and credibility of auditors (Power 1999). Or in other words did the comfort created by auditors transfer from the auditor to users via the EAR. And as identified in chapter 6, users expressed multiple concerns about the credibility and trustworthiness of auditors and audit profession. So, I asked the auditors to reflect on these concerns where their responses are presented in the next section.

7.4 Theme 3: Auditors' reflection on the concerns raised by users

After analysing users' interview data in chapter 6, the analysis showed that users do not trust auditors and audit firms' essence in terms of independence, accountability and competence. So, I asked the interviewed auditors to reflect on the users concerns in these three areas of concern.

7.4.1 Sub Theme 3.1: Users lack of trust in auditors' Independence

The interviewed auditors when asked about their independence they all agreed that the UK market is well regulated and the independence rules for listed entities have improved significantly over the recent years. And they attributed the negative views of users to legacy issues when the independence rules were less strict. As AUD11 explains:

“And there's maybe some legacy issues in the market now, currently under investigation, but this is something you will find it even across all the big four. And this is mainly coming from legacy issues like six years ago or maybe more. Because it was a grey area at that time, mainly the audit firm can deliver the audit service, and sometimes at the same time providing tax advice or something related to internal control or some development, something related to the advisory or consulting.”

“Previously, it was allowed to provide non-audit services to some of the listed clients, so audit firms can turn around the rules and regulation and just find in a way or another that they can do this without compromising their independence. But now the rules are a bit more aggressive, I would say, here in the UK. So now we are banned to provide any non-audit services, as you definitely might know, to a listed client” AUD10.

I then went on to ask auditors to reflect more specifically about the issues raised by the interviewed users.

Hiring of Auditors and fee dependence on auditees:

Most of the interviewees had no doubts about their independence from the auditees despite being paid by the auditee.

“Auditors needs to be independent of the entity auditing and it's a very important issue that needs to be taken care because that will give kind of quality that's going to be attached to whatever opinion that has been given by the auditor. So, yeah, independence is really important. yearly you have to declare your relationship in terms of you look at your client's portfolio, you have to declare if you have any family relationship, business relationship, or any kind of relationship you might have with the client. And that will determine we have to assess the risks associated with that and be able to see whether you're going to be put on that client or not. Especially a lot of people are relying on our work, because as an auditor, if you give your signature to say that we can affirm that this statement of account is free from any material misstatement, people have high confidence. So, if people are going to put much confidence in that document which we've signed, then that means independence should be taken, should be taken with all seriousness” AUD04.

AUD15 also emphasised the due process they must follow to ensure their independence:

“We are subject to these independence rules and it's a very strict thing, which need to be followed up very seriously. We consider all the audit team members are independent and we need to disclose if we have any investments or anything. So that's something that we do that's normally done at a manager level because that would be only people who are at a high level can influence the results of the audit rather than the staff below. So that's why managers and above have to do that, declare their investments, declare their immediate family members investments, which includes your spouse, your parents, we go to that level. So you need to do

that so to ensure that you are independent. We do an annual independence declaration every year. We have these trainings where we are told of various instances which could probably impair your independence. So, everybody goes through that.”

“We are completely independent. An entity who wasn't independent for any reason wouldn't be allowed near the audit file.” AUD12

AUD11 confirmed the lengthy and robust process for new client acceptance to ensure independence:

“For me, now, that just to accept a new client. The process of acceptance to the client, only can take up to around one month or more. And now we have segregation of duties or separate roles. So, it cannot be only like one decision by the engagement partner, same as old day. So now we have a separate department to assess the independence and then they have a second reviewer from risk management team and then if something requires or high risk it goes to a third level in the risk management partner and a written memo from the audit team who will deliver to the audit to assess the situation. And we have separate team to run research about the client and the services provided or delivered to this client, not even in the current year or even the last two, three years to assess if we impair the independence or not”.

AUD05 emphasize that the tone at the top in his/her audit firm is audit quality and that they are willing to let go of the auditees if they would have a negative impact on their reputation:

“Like the head of audit used to say, if the bad ones that don't want to cooperate, want to go, they should go. The ones that do appreciate what we're doing, they will stay. So we are not really dependent on the auditee because we know we want to get the tender, we want to get the job, but if there are bad claim against us, it will be a reputational damage cause actually if we have to please them and then FRC take the file up or we do have our own internal review as well”.

However, AUD07 highlighted a potential issue in smaller practices:

“Well, I think in theory they are independent, but in practice, if you've got different audit sites around the UK, for example, let's say you've got a really small office in Derby and you haven't got a lot of clients, you're going to be trying to keep that client the best you can, so that plays a part. Whereas if you're an audit office space in London and there's a very big churn, you lose one client, you're going to get another big one, maybe not such a worry. I'm not saying that the ones in the regions would be more likely to commit fraud, but it does blur the edges as to if they want to keep the client, at the same time they should be assessing the client. That, in my mind, is you are kind of sitting on both sides of the fence”.

Furthermore, AUD12 and AUD15 pointed out that it can get tricky dependent on the auditee to maintain the operational independence (Power 1999) as auditors need the auditee support to collect their audit evidence. But unlike the results of Guenin-Paracini (2015) research, they feel confident that they are still independent:

“It is about having an effective client relationship because you ultimately have to challenge your client. So, people kind of say, okay, I've got a really good relationship with that client. What does that really mean? Are your best friends with them? Are you too close for them? Are you kind of talking about holidays and laughing at all their jokes sort of thing? Or do you have a really effective relationship where you've got the respect and you're challenging them? You're able to obtain the information that you need to obtain from them. That's what having an effective relationship is. And I mean, it varies from client to client. To some clients, it's much easier to build that relationship. Some other clients are much more challenging to auditors. They think, oh, no, I don't think you need that. We can give you that, but they fall

behind or we can give you that in two weeks' time sort of thing. So, I mean, very much varies client to client, person to person" AUD12.

"There are like at times it does really get difficult to manage that kind of relationship because at the same time you want stuff from them, you want them to provide this at the same time you don't want them to get upset or whatever because they are your clients. You get familiar, but at the same time, everybody has a code of ethics that they have to follow. I think probably there could be things like where we could have people changing, say, after every two years rather than five years" AUD15.

Moreover, AUD08 and AUD05 highlighted instances where they had delays from the auditee in providing the required evidence, but they still managed to stay independent and do not compromise on audit quality.

"I used to be very transparent with the client on what we need, on at least twice a week call, like we used to have twice a week call with a client talking about all the open items. So, nothing shouldn't be coming as a surprise to them. So, we are working toward, let's say, December 31 due dates for a company's year-end as of October 31. It's a two-month audit period. Now you know what we need. So, on December 31, if we don't issue because of this, you know why we didn't issue. And that means we put the ball in their court. It's not in ours. And it happened a lot in the past. It just happened to me. I was auditing a company that has June 30 year end. We were supposed to issue in August, in August 15. We didn't issue in August 15. We even passed August 31. And then we issued in September 15. So, they knew this was coming. And we had a meeting with the audit committee, and we talked to them why we couldn't issue because we were not comfortable to issue on that date. They were not happy. They were not happy. But was it new? It wasn't. So did I feel empathy and sympathy for them, yes, they have my support, but at the same time, you can tolerate to a limit" AUD08.

“Audit clients were slow with actual information. They didn't give us the required documents over two weeks. We were wasting resources. We were going back and forth. Whatever they gave us is not right. And all that. At the end of the day, we told them at a meeting, you guys wasted 20 days of our time that we should have spent on something. We thought, you guys are ready. We are going back and forth. So, we are going to charge you extra. They couldn't say no because they do understand the fact that truly they did waste our time” AUD05.

Eventually as AUD11 and AUD02 explained that auditors report to the audit committee who are non-executive members of the board which ensure their operational independence:

“We have to comment on the performance of the finance team, CFO and the finance managers in front of the Audit committee because the audit committees have active and the non-active members of the company. So, they have two independent members and the audit committee, they are not related to the company. So, they assess our communication and our observations to the Audit committee. And one of the requirements is to comment on the performance of the finance team” AUD11.

“You have a trouble with management. You have a very regular meeting with your audit committee and that's the place you say, listen, I can't do my job. Because if things have come to that point, then I think management has to really think hard whether they want that discussion between the auditors and the audit committee” AUD02.

Provision of Non-Audit Services:

One of the main concerns raised by users was the lack of independence of auditors when they provide non-audit services to audit clients. As indicated earlier in this chapter auditors agreed that this is a legacy issue as it is no longer the case for listed clients. They also highlighted the very thorough process to make sure that this is no longer the case:

“We have tough regulations in the market, and we have a close monitoring for audit firms to keep the independence and separating audit services provided by the audit firm for assurance services and the non-assurance services. Because now, currently we are prohibited of delivering any kind of consulting or advisory to our audit clients. So, we have a tool now to oversight this process. We have a new portal with all the information of that client, and no one can access any kind of service, that's going to be provided to this client. It should be accessed by a separate team. And this team is responsible for independence. So, I can say now, highly independent. And in the UK, we have regulations now to separate the audit firms or the consulting firm to separate legal entities, like to keep the Assurance services under separate legal entity and to keep consulting and Deals services under a separate legal entity. They are not related. Which I see it as a very good action, so it can prevent any independence issue and KPMG started this process already last year. And even they changed our email address. So, we have now a separate email address. The other team, they have email address like at kpmg.co.uk and another team like kpmg.com just sitting in a separate floor, but legally separated than us. So I feel like the current procedures now, it's getting the auditor independence to the highest level” AUD11.

“Non-audit fees. We're having to reject work on the basis that we have to keep the ratios appropriate, and we can't provide too much non audit services to a listed client. I'm involved in engagements where we are rejecting work because we just can handle the budget in the ratio. We've got to keep it independent, so we had it rejected. That is definitely something, we are extremely careful of” AUD12.

“I don't have any concern on the independence. So, for all my professional years in this profession, I didn't see any independency issue. We always act independent all the time. It doesn't matter if there is another team in the firm like consultancy or tax are providing services, we will still keep our independence, right? They may help us in understanding the entity more,

the transactions more, but all the time we stay independent. We are responsible for our work, and we do it independently. We don't compromise that” AUD01.

However, for non-listed clients where some of these services are allowed there was a distinction made based on whether the audit firm is from the Big4 or non-Big 4. As AUD06, AUD10 explained that they agree the pressure is high and they can relate to the points made by the users:

“Especially the Big Four have very aggressive revenue targets for their audit teams to go get non audit fees, sell additional services. It is not easy. I'll tell you honestly, it is not easy. And there's a lot to work through when you are, to your point, trying to be cordial and nice to the client because you're trying to sell something, and the same client deliver an audit report with 20 findings on a regulatory issue” AUD06.

“From my experience in the big four firms, I've been looking for a lot of these. It is much more harder when you are in a big four because of the targets, or I would say the revenue targets imposed on the other partners and accordingly the audit manager. So, they are always afraid to lose the big clients. So that's why these scandals are coming from the big four mainly, I would say. So, it is much more harder to manage this within the big four, giving the big targets that you set for them” AUD10.

AUD02 went further arguing that we should focus on the root cause of why audit firms need to provide non-audit services which is the limited audit fees:

“And you touched on the thing that I find quite amusing sometimes to hear discussions about auditors who want to do all these additional non audit services to compensate for the fee that they are not getting for the audit. And I think that if everyone recognizes that that's a risk, then why create the environment for that risk to arise? Why just not properly make sure that auditors

are properly remunerated so that they don't have to go and look for non-audit fees?"

AUD02.AUD02 explained further:

"One of them, I guess, quite important factors to ensure auditors are independent is making sure that they are properly compensated to do their job. I think poor independence came more for having to rely on few clients because those are the ones that are maintaining your business. And I think that goes back to my fee discussion. If you have three clients that are paying good enough so that you maintain your company, of course you're going to be independently, indirectly, you are reliant on them for your company to operate. But you wouldn't have that problem if there was proper, if your other 100 clients would have paid well enough so that you don't have to have that pressure" AUD02.

Conversely AUD08 argued that Big 4 have better systems and global networks to ensure independence in case of the provision of non-audit services than the non-big 4 and gave the example below:

"It depends, a few things to consider here, right? First it depends on the firm itself. And the reason why I'm telling you that is because I work for three different firms. So, the independency is one of the very very complex areas that we have to take seriously because it can create a lot of conflict. And some of those conflicts are not even known unless we get inspected by the FRC. So, some firms, they have very strong independent structure where it has to go through websites and those websites list out all the services that are being performed or delivered to this specific customer and all the other entities that they are affiliates to this customer or client. They are listed there and what type of services are prohibited, what type of services are allowed, and whether you are a covered person. Whether you are not a covered person. Everything is there. One of the things that actually, I would say non-Big Four firms should work on is creating or establishing this structure. Because if you look at the inspection report by the FRC, you'll be

able to tell that Big Four has less inspection findings when it's related to independence. And the reason why is because they have very strong system around how they communicate globally on those, and because they have a global existence, their system requires them to have this strong structure. Otherwise, you can have. And I personally experienced that with EY many times where we were offering a service for a company and this company was going public and we noticed that the owner of the company we are auditing actually, or the prospective owner is investing in another company in Australia that they are providing a consulting service to Australian government. And we are not allowed to audit a subsidiary of a company that owns another investing company where EY is providing consulting service to the government. So we had to stop. We told them we can't go public. So, keep in mind the whole structure about this. If you don't have this complex and then you go and talk to the partner in Australia, which service is more important? Like if the audit is maintaining a long-term relationship with the customer, with the client, but the consulting service provides more money? To your point about the consulting services, which one is more important? So, it's a management decision now at EY level to make that determination, which one should seize, which one should continue. My point being, I think if companies or firms with global footprint, they have very strong independent system. I'm not saying it's perfect, there are some holes in there, but I would give it probably eight to nine out of ten. With local firms, I would give them maybe five out of ten. Four or five out of ten” AUD08.

AUD06 also highlighted that audit committee can play an effective role:

“Some companies actually, one of my clients, one of the very well-known names that I've spent quite a bit of time with them. Their policy was, we do not sell you. You do not do anything for me other than the audit. Their audit committee is very conservative. They did not want to deal with any potential issues, any potential bad press, anything. Their policy was you are only our auditor” AUD06.

Audit Tenure:

Most auditors were more supportive of tougher rules for auditor rotation by rotating the whole audit team not just the engagement partner more frequently as they acknowledged it is negative impact on the auditors' appearance of independence, as AUD10 explains:

“Yeah, this wasn't really helpful and healthy for the profession when you've got an auditor for more than ten to twenty years doing this statutory audit. But again, the rules are now more a bit aggressive in the UK. The auditor shouldn't be I mean, the person or the auditor themselves, not the firm, should be rotating each five years. Yeah. And even then, I think they should add on this the manager or the senior members of the audit team as well. So now I have an example that the audit partner has been rotated after five years, but I'm still doing the job as an audit manager, I'm still doing the job. So, I would say that to refresh the market, to be more healthy, to make sure that the independence is there, I would say not only the auditor that should be rotated, not only the person or the partner himself, it should be the whole firm” AUD10.

Furthermore, it improves the professional scepticism and eliminates familiarity

“I would say rotating the whole team, we can bring those years down because five years, seven years is still a lot and not just for independence purposes, but in terms of the team's overall development and learning, rather than, you know, saying, we've got people who are just working on one time for the whole year, for the last five years, five years, it's the same thing” AUD15.

“If the audit tenure is long and this is because usually the teams do not change, people get familiar with each other, and this has a negative impact with the independence of the auditor. Moreover, this depends on the auditee most of the time, on what kind of approach they have towards the audit firm. The whole Audit team needs to have rotation every 1-2 years; however

this will have impact on the cost side since more time is needed for new members to learn the client, especially if the client is big, in my case Banks which are quite complex” AUD03.

“In the UK. I know it's like changing the partner only, but I feel like it's more hectic for rotating the whole audit firm, but it is good to have a fresh perspective and have different points of view to assess. Yeah, it's more hectic if it will happen like every three years, but for five to seven years, I think it's enough to it or this is the right time to move to another audit firm” AUD11.

These findings support Carey and Simnett (2006) research where longer audit tenure was associated with lower audit quality.

Conversely, AUD12 argues that there are other downsides to rotation:

“I actually think there's a strong argument for not changing your auditor too often because it takes so long to build up a really robust understanding of a company. And it's about being able to ask the right questions and kind of know where the errors are and know where the risks are getting to really know the numbers. So, I think that I wouldn't be an advocate of accelerating that at all. The main benefit of that is more about the perception of independence. And I think that's the main thing. It's about the public's perception that, yes, they are independent, they've not been involved too long. And I think that's the main reason for doing it, rather than reality of doing a better audit, because I don't think it owing to the audit quality.”

These findings support Dart (2011) study which found that UK investors are less concerned with auditor rotation compared to auditors' economic dependence on the clients and the provision of non-audit services. Similarly, in Australia Kaplan and Mauldin (2008) did not find a significant difference between rotating and keeping auditors in their experiment on MBA students. The participants valued the presence of a strong audit committee than rotating auditors. Ruiz-Barbadillo et al. (2009), did not find an improvement in independence (using the likelihood to issue going concern opinions as proxy for independence) as a result of

mandatory auditor rotation in Spain. Furthermore, Cameran et al. (2015) did not support mandatory auditor rotation as they did not find an improvement in audit quality, and this was attributed to the loss of the in-depth knowledge of the auditee without any corresponding benefit in audit quality.

7.4.2 Sub Theme 3.2: Users lack of trust in auditors' Accountability

Users indicated they lack trust of effective accountability of auditors. However, auditors disagree and argue that they face tough regulation and their work is reviewed both internally through the Audit Quality Review (AQR) inspections by audit partners from other offices within their audit firms and externally by the FRC as explained below by AUD15 and AUD13.

“Auditing over the years, it's just getting more and more tough for us because of the regulations. Now we have to do far more than we used to do earlier. We are subject to AQRs which is called an audit quality review. And that is done internally as well, and externally is done by the regulators. So, the FRC and all. One of our partners says I always think if I am put in the court, if I'm standing in the court and somebody asks me how have you done this, I should be able to answer it. So that's a very big thing. So, because of that, the clients, when I say clients, it's like the directors, the managers who we deal with because it leads to us doing more work. They don't like it because it's more work for them, we need to do more work. But then again, we are bound by these regulations, by the FRC, whatever. Every year there's something new, every year something's happening” AUD15.

“And apart from the normal audit and the partner signing the report, there are other tests in place which make sure that the opinion that we give it is right. So, there are FRC reviews and then there is quality reviews. So, I think from that it's like a double check, our work, whatever we perform is double checked, I would say” AUD13.

Big 4 market concentration:

As for the oligopolistic nature of the audit market, AUD05 agrees that something needs to be done to break this monopoly up:

“What they could do is to break the monopoly of the top four. There is too much monopoly in the market. They have occupied the market. And I think that's actually a problem because that's why it's common for the top four when you see all these issues coming up, because they've picked up so much, it's not easy, crazy hours and all that kind of stuff. They pick up so much audit that auditors that are doing the job have so much on their plate. Either they are under resource or there's too much to be done. And when there's too much to be done, you're going to dilute the quality. When you dilute the quality, it's going to have an effect on the organization as a whole.”

Conversely AUD12 disagrees that Big 4 are too big to fail:

“The thing is, that anyone that says too big to fail or will never fail. I mean, look at Anderson. Yeah. And it was the big five. Nobody's too big to fail” AUD12.

And there are reasons behind this dominance of the Big 4 due to their high standards of Audit quality:

“I don't know if you saw the FRC results must have been a month ago or so, and you saw the kind of Grant Thornton, your BDOs. I mean, they got absolutely hammered by the FRC in audit quality. They got absolutely annihilated, so they are your next biggest firm. The FRC gave them a very hard time. I think focus should be on audit quality. I don't want to talk badly about another firm, I would leave that to the FRC to do so. I would say the audit quality is such a key focus for us, all the big four, and I'm just not sure it's quite the same focus outside of the big four” AUD12.

Moreover, AUD02 argues that some of the big listed clients cannot be audited by non-big 4 who lack the resources:

“The entities that we are auditing and maybe this is driven from my experience of always being part of really big sort of conglomerates, but in my experience, the entities we are auditing are

getting bigger and bigger and bigger and bigger and more complex. Because, for example, I used to have clients that are very focused on banking and now you have a bit of banking, a bit of insurance, and they all consolidate them in one parent, why in one side we are seeing this trend of sort of entities combining and why the auditors have to become smaller. And also, what does that tell me about resources? Because I think the smaller the firm is, the less access to resources it has.”

When asked about the possibility of join audit suggested by Brydon review (2019) and the Competition Market Authority (CMA) (2019), which suggested mandating joint audits to counter this problem, AUD02 was not sure how the responsibilities would be divided and whether auditee can handle having two auditors simultaneously given his/her experience with shadow auditing:

“I did shadow auditing, which basically means you're just sort of following the going auditor as you are preparing to start your first-year audit. And I found from the client's perspective, having to deal with two auditors is a nightmare. I am yet to see what the benefit on that (joint audits) is.”

7.4.3 Sub Theme 3.3: Users lack of trust in auditors' Competence

Users had concerns about the technical competency of the auditors when it comes to complex financial instruments and valuation models. All the interviewed auditors indicated they spend a lot of time to properly understand the business:

“We do like a walk through to understand the process, the controls and everything” AUD05.

Additionally for complex valuation and financial derivatives they hire external experts to perform these valuations.

“If something is more complex and more technical, we hire a new external expert to assess” AUD11.

“We also have our own external valuer that we use to make sure to check if everything that they've done is appropriate, if they've done it appropriately. And a perfect example is one of the clients that I did. They've used a formula that I've never seen in my life before. So, I saw this and I was like, this is not right. And then I took it to the Engagement lead who advised to go, and that I should ask quality lead. So, I went to the quality lead to ask them, quality lead who never seen it before. They said, we have no clue and that I should go and meet our external valuer” AUD05.

However, the importance of appropriate audit fees emerged again to highlight its important knock-on impact on auditors' competence as AUD02 argues:

“Also, to attract talent and maintain talent. You know having senior audit partners looking at your areas of significant risk costs money. But you need that expertise because otherwise you could have a team of hundred people, and because they are supposed to look and apply judgment, it's difficult to apply judgment if you don't have the expertise behind you. I think personally, and this might be a bit of it might sound ignorant, but I have never understood this scrutiny behind the audit fees can't be high because for me, I would be more worried if the

audit fees get lower and lower. I think for me that would be really risky because then I would question what is the auditor doing to make sure that they're still doing a good job?" AUD02.

Additionally, users had concerns about the level of seniority in the audit team. Auditors argued that given the thorough review process by the engagement partner, second review partner and risk management partner that should not be a concern. However again the audit fees have an important impact on the level of seniority in the engagement team composition which poses significant risks to auditors as argued by AUD09:

"There is a big competition between the Big 4. We know it is a war. Everyone tried to get the biggest client with lowest fee as much as possible. Then of course, they try to make more money with some extra services and so on., having pressure on the fees, the audit partner, the company still try to make money because they have some profit target on that. So, they put on a big engagement, 20 junior staff rather than ten good managers and this will impact the auditor's result, in my opinion. Even if you look at a standard audit team, you have one partner, one senior manager, and then most of the team is mainly junior staff plus one senior. I think that they don't have the sensibility, the expertise and the professionals to identify all the risks. So, the balance between more senior roles compared to less experienced roles to me is key."

7.5 Summary of findings

The analysis of the auditors' interview data helped me to address the third research question

RQ3: What is the auditor's experience of implementing the EAR? What are their reflections on the concerns raised by users?

Auditors view the EAR as a step in the right direction and using the audit comfort framework (Pentland (1993); Carrington and Catusus (2007); and Guenin-Paracini et al. (2014)) as the theoretical lens, I contend that the auditors use their comfort building strategies to achieve the relief sense of comfort. Which in turn creates a state of comfort and move from the discomfort feeling associated with the risk of failing to detect material misstatements and arrive at the incorrect audit opinion when they produce and publish their audit opinion in the audit report (the symbol of comfort). Therefore, auditors build comfort through audit team members' interactions at the micro level with the auditee personnel, the audit committee, within the engagement team of auditors, within the audit firm and ultimately transfer this comfort to the users of the audit function through the EAR at the macro level.

However, the production of the EAR involved four challenges facing auditors as the preparers of the EAR related to summarising the audit effort in one report, pressure on audit fees, time pressure and litigation risks.

Eventually auditors reflected on the concerns on their independence, accountability and competence raised by the users. The results show that auditors' comfort is not always transferrable to users, due to a perception gap between auditors and users cornering some of the views regarding independence, accountability and competence of auditors. Hence, there is a need for a more nuanced analysis of the views of auditors and users to be able to offer useful recommendations which is presented in chapter 8.

Chapter 8 Discussion of Findings, Conclusions and Recommendations, Research Contributions, Limitations, and Areas for further Research

8.1 Introduction

The aim of this research was to develop an in-depth understanding of the impact of the introduction of EAR on its users and preparers by addressing the three research questions:

- RQ1: Did the EAR succeed in repairing Auditor's legitimacy?
- RQ2: Do users trust the information in the EAR?
- RQ3: What is the auditor's experience of implementing the EAR? What are their reflections on the concerns raised by users?

This chapter begins by offering a summary of how the analysis of the interview data findings from the two empirical chapters (Chapters 6 & 7) addressed the three research questions. This is followed by consolidation of the users and auditors' views on reasons behind lack of trust in the essence of auditors through the data analysis, to synthesise the research conclusions and recommendations. Afterwards the research empirical, theoretical and policy contributions are highlighted. Then, the research limitations and areas for further research are presented. Eventually, the chapter concludes the thesis with concluding thoughts.

8.2 Addressing the research questions

8.2.1 Addressing the first research question

RQ1: Did the EAR succeed in repairing Auditor's legitimacy?

The analysis of the users' interview data using the theoretical lens of Suchman's 1995 theory of organisational legitimacy, showed that the EAR as a legitimating tool succeeded to repair legitimacy in auditors' actions as doing the right thing, as users welcomed the new information in the EAR as a step in the right direction. The EAR and its disclosures about KAMs, materiality levels and the auditor responses to these risks, opened the black box of audit work which gave procedural moral legitimacy to the auditors' actions as well as understandability component of cognitive legitimacy. Moreover, interviewed users even the most sceptical ones acknowledged the importance of the EAR in making their investment decisions by giving new information about the audited company's risks or confirming information that they have from a different source. This was not visible before in the one-page audit report before the introduction of the EAR. Thus, the EAR achieved pragmatic exchange legitimacy for its users.

However, the EAR failed to repair the legitimacy for the auditors' essence as users do not trust that auditors are the right social actor for the job. In Suchman's analytical typology the EAR failed to achieve the dispositional pragmatic legitimacy, the moral structural and personal legitimacy as well as the cognitive taken-for-grantedness legitimacy. The reasons behind this lack of trust were addressed in the second research question.

8.2.2 Addressing the second research question

RQ2: Do users trust the information in the EAR?

Interview findings showed that users do not trust the information in the EAR as they have serious doubts about the independence, accountability and competence of auditors that affect their level of trust in the information included in the EAR. Using Sztompka (1999) social theory

of trust and its sources as the theoretical lens to understand the users' reasons for the lack of trust in the essence of the auditors. Findings show that trusting the EAR implies more than trusting a report, it relates to trusting individual auditor who prepare it, the accounting firm where they work, the regulators who oversee their work and the auditing profession as a whole. Absence of Sztompka's primary sources of trust applied to the context of auditing relates to auditors' appearance in terms of the serious doubts about auditors' independence given their fee dependence on the auditees, provision of non-audit services and lengthy audit tenures. Moreover, auditors' strained reputation given the widespread accounting scandals and audit failures featuring on a weekly basis on financial news (FT 2023). Furthermore, the lack of trust in auditors' present performance in terms of auditors' competence and the sufficiency of experienced staff in audit teams. Additionally, users indicated the absence of the secondary source of trust in the accountability of auditors to the regulators. The lack of trust in the regulators relate to users' concern of regulatory capture due to the prior affiliation of regulators to the big 4 accountancy firms. Moreover, the oligopolistic market for audit services, gave the users the impression that auditors especially the big 4 are too big to fail and that the regulators cannot afford to have another Arthur Anderson as the big 4 dominate the audit market for the FTSE 350 and the non-big 4 do not have the capacity or resources to fill the gap if one of the big 4 goes down. Taken together, all these reasons led users to have serious doubts about the independence, accountability and competence of auditors and the audit process. This is particularly relevant in auditing context as users do not have any personal knowledge of auditors or face to face interactions with them, thus as Sztompka (1999) argues, legitimacy cannot be a substitute for trust and users need to trust the auditors first before they can trust the information they provide in the EAR. Users appreciate the expansion and the extension of the audit report however due to their lack of trust in auditors' independence, accountability and competence they do not trust the information included in the EAR. A detailed summary of the

reasons behind the users' lack of trust in auditors' independence, accountability and competence is presented in section 8.3 below where they are compared and contrasted with the auditors' reflections on these reasons.

Addressing the first two research questions indirectly shows that the EAR succeeds and fails at the same time to reduce the information gap component of the audit expectations gap. It succeeds as users value the addition of the KAMs and materiality disclosures by auditors and simultaneously fails as users do not trust this information.

8.2.3 Addressing the third research question

RQ3: What is the auditor's experience of implementing the EAR? What are their reflections on the concerns raised by users?

Similar to users, auditors view the EAR as a step in the right direction and using the audit comfort framework (Pentland (1993); Carrington and Catusus (2007); and Guenin-Paracini et al. (2014)) as the theoretical lens to analyse the auditors' interview data, auditors use their comfort building strategies (relief sense of comfort) to create a state of comfort and move from the discomfort feeling associated with their audit risk of arriving at an incorrect audit opinion in the EAR as the symbol of comfort. Therefore, auditors build comfort through audit team members' interactions at the micro level with the auditee personnel, the audit committee, within the engagement team of auditors, within the audit firm and ultimately to transfer this comfort to the users of the EAR at the macro level.

However, the production of the EAR is not without challenges. Auditors as the preparers of the EAR identified four challenges in the preparation of the EAR: summarising the audit effort in one report, pressure on audit fees, time pressure and litigation risks.

The first challenge relates to summarising the audit effort contained in their audit file into the EAR. Auditors find it challenging to decide how much information to include in the EAR, as

they must strike a balance between putting too much information from the audit file with the risk of overloading the users and having an extremely lengthy EAR in an already lengthy annual report and not putting enough information to satisfy the different information needs of the users of the EAR.

The second challenge relates to the increase in their costs from preparing the EAR while facing constant pressure from the clients on lowering audit fees. The EAR is an expensive document prepared by the most senior audit team members, which does not support the conclusion of the prior archival literature that the EAR has no impact on audit fees as the information is already available in the audit file. While auditors agreed that the KAM's and materiality disclosures and other information in the EAR is not new to them as it is already there in the audit file, summarising the information and choosing what to include in the EAR is a very challenging task that require a lot of effort as explained in the first challenge. As the audit file is a massive, detailed document, where the longest EAR is still a brief summary of the audit effort. Moreover, the extra pressure is not just related to audit fees, it is related to time.

The third challenge identified is the time pressure as auditors explained they have a really short window to audit the financial statements and the annual report of approximately 2 months. Even with interim reviews, the big Public Interest Entities (PIEs) have complex transactions and auditors need time to truly understand the business and ask the right questions to satisfy themselves about the fairness of the financial statements especially with the constant innovations and Mergers and Acquisitions (M&A) activities resulting in huge conglomerates with very complex transactions that exacerbates the time pressure on auditors.

The final challenge identified was the increased litigation exposure for auditors as a result of the EAR and its disclosures made by auditors. Auditors' opinion split on this with half of the interviewed auditors believe that there is an increased litigation risk as auditors identify KAMs relating to accounting estimates which are inherently uncertain, and users can use this against

them with the benefit of the hindsight. The other half argues that the EAR has no impact on litigation risk as what really counts in courts is the audit file not the EAR.

Auditors also reflected on the reasons identified by users for their lack of trust in the auditors' independence, accountability and competence, with their reflections contrasted to the users' reasons presented in the next section 8.3.

8.3 Consolidation and Discussion of Findings from the two empirical chapters:

After addressing the three research questions it is clear that a perception gap exists between users and auditors when it comes to auditors' independence, accountability and competence. This perception gap means that despite the potential of the EAR to reduce the information gap component of the audit expectations gap as it provides new information about the audit process and opens the black box of auditing, the expectation gap persists. Although users have more information about the actual conduct of the audit process and how auditors arrive at their opinion in terms of the KAMs, auditors' responses to these KAMs, materiality levels and auditors scope given these KAMs and the materiality levels, they do not trust this information. The reason behind this distrust, is that users do not trust the auditors' themselves who prepare the EAR or the regulators who oversee their work. Here the research makes an original contribution to our knowledge in the audit expectations gap literature, by highlighting that it is not just a question of what information is provided by auditors to users, it is a question of whether users trust auditors first to be able to transfer this trust to the information contained in the EAR. And for any successful effort to reduce the gap, an in-depth understanding is required on how to rebuild trust in auditors' essence as the right social actor for the job.

Consolidating and analysing the views of users and auditors helps to further explore this gap and provide recommendations to bridge it.

8.3.1 Independence

The importance of auditor's independence has been recognised in the auditing literature as early as the pioneering work of Mautz and Sahraf (1961) on the philosophy of auditing, identifying independence as cornerstone concept. Similarly, Flint (1988) recognises as a fundamental element of auditing. However, auditors inherently suffer from what Mautz and Sahraf (1961) describe as "built-in anti-independence factors". The most significant factors that are subject to academic research and were also identified by the interviewed users are auditors' economic dependence on the auditee, provision of non-audit services to the auditees and long audit tenure.

There seems to be a big perception gap between the users' and auditors' views on the independence of auditors. In general users doubt that given the current structure of the auditing process and how auditors are hired and compensated that auditors can still be independent of their audited clients. Alternatively, auditors believe that they are truly independent and are subject to robust series of policies and regulations both internally at the audit firm level and externally at the regulatory level. And they attribute the users' lack of trust to legacy issues when the regulatory environment was more lenient, which is no longer the case. There are only few points of agreements between the users and auditors on how to address this lack of trust. The main themes identified by the users relating to their reasons for lack of trust in auditors' independence along with the auditors' reflections on these reasons are discussed below:

8.3.1.1 Hiring and fee dependency

For the users the fact that auditors are paid by the companies that they are auditing is a deal breaker as they perceive that auditors can never be truly independent (in appearance or in essence) when this is the case. While auditors believe that given their robust and lengthy policies and procedures of ensuring independence from audit clients, that they are 100% independent from their clients. These policies involve training on how to maintain

independence, checks of conflicts of interests for the audit team members and their immediate family, and a separate department to oversight independence including risk management partners other than the engagement partner to make the client acceptance decisions. Furthermore, the fact that they report to the audit committee who are non-executive members means that their independence is further enhanced and that they are willing to drop clients if they would potentially impair their independence. However, users are still sceptical about the effectiveness of audit committees given the possibility of board interlocks that became visible with the benefit of hindsight during major accounting scandals (Chiu et al. 2013).

Additionally, auditors acknowledge that in some settings the fees pressure might result in high dependency on the auditee especially in smaller offices with limited number of clients. Taken together, users are not fully aware of the auditors' procedures to ensure independence, so auditors' need to communicate them to users in their EARs. Even with that communication it is really hard to establish Sztompka's primary source of trustworthiness which is in the auditing context is the appearance of independence. So as result, the plausible course of action is to change the structure of how auditors are hired. Specifically, both users and auditors agreed that auditors' independence will drastically improve, if auditors are hired and paid by an independent third party like the securities exchange within which the audited company is listed.

8.3.1.2 Provision of Non-Audit Services

Users contend that NAS are much more profitable than audits as NAS represent a one-off cost to the companies, while audit is an annuity of costs that companies are constantly trying to reduce. And as users view audit firms as a for profit partnership, they will always scrutinise their incentives. Even with the new regulations in the UK prohibiting auditors from providing a wide range of NAS for listed clients, users still doubt whether this is effectively implemented. As USR06 explained audit firms can still find a way around the regulation without violating it. For e.g. even if currently the audit firm cannot provide NAS to their listed audit client, they

might still anticipate this as a potential client in the future when the audit rotation kicks in. Furthermore, the fact that the Big 4 started to separate their consulting arm from their auditing arm is still contentious as users doubt whether it is a real separation or just a symbolic one. Additionally, that separation has not yet been implemented by all of the Big 4 as KPMG did the separation, Deloitte, EY and PwC went against it, where EY senior partners recently voted against what was called “Project Everest” (FT 2023a; FT2023b; FT2023e).

Auditors on the other hand, acknowledge the pressure on audit fees but maintain that they are still independent and following a due process to make sure that they follow the independence rules and there are no conflicts of interests, where many examples were given by the interviewed auditors of audit and non-audit clients they had to drop to avoid such conflicts of interest. They agreed that auditors need to be properly compensated and audit fees need to improve to relieve that pressure. They also recommended to prevent the provision of NAS to non-listed clients as it is the case with listed ones. There were 2 arguments presented by the interviewees on the impact of the audit fees pressure on the Big 4 auditors versus the non-big 4 ones. The first argument is that Big 4 auditors face more pressure due to their aggressive revenue targets and this is evident by their involvement in most of the accounting scandals. Conversely, that big 4 auditors have more robust global connected system of controls that prevents conflict of interest that non big 4 cannot establish. And the fact that the major accounting scandals involved a big 4 auditor, is simply related to their market share auditing almost all the big listed clients. All in all, audit fees pressure is acknowledged by both users and auditors, so making sure that auditors are properly compensated would positively impact their independence and preclude them from the provision of NAS.

8.3.1.3 Audit Tenure and Audit Rotation

All the interviewed users agreed that long audit tenure is detrimental to auditors’ independence as they become too familiar with their auditees to a degree that they lose their professional

scepticism and become more of management advisors than auditors. They all want to see more frequent rotation than the current regulations of mandatory audit partner rotation. They want to see rotation of the whole audit team within the audit firm. Moreover, they need more audit rotation of the whole audit firm as well. They acknowledged though that this is a tricky task given the oligopolistic nature of the audit market and the fact that smaller sized (non-Big 4) audit firms do not have the scale or the resources to audit big listed clients.

Most of the interviewed auditors agreed with users' viewpoint that more audit rotation within the firm and the whole audit firm rotation as this provides a fresh perspective and maintains the auditors' appearance of being independent. Furthermore, it provides more learning opportunities for the auditors in different client context. However, there is a trade-off involved as the long audit tenure helps auditors to have an in-depth understanding of the auditee and its related risks, which enable the auditors to ask the right questions.

Given the current UK regulations, PIEs must change their auditor at least every 20 years and offer the audit contract to tender at least every 10 years. This came after the introduction of the mandatory audit rotation by the EU in 2016 where some UK PIEs had the same auditor for more than a century. The problem is that result in a game of "musical chairs" given the dominance of the Big 4 who get 98% of the audit fees of the FTSE350, where even after the tender of audit contract, some PIEs still retain the same auditor as the recent example where HSBC retained PwC as their auditor for another 10 years (FT2022c; FT2023). So, it is still not clear how effective is the implementation of the current mandatory auditor rotation, however both users and auditors agree that more effective rotation is the way forward to improve auditors' independence and professional scepticism which ultimately results in better audit quality.

8.3.2 Accountability

The users expressed their lack of trust in the accountability of audit firms, and the regulators becoming toothless as they only issue reduced fines and penalties to big audit firms who settle them outside courts (Sikka 2022; FT2023f). For e.g. PwC have just been fined £5.6 m reduced from £7.5 m by the FRC as PwC agreed to settle for its failings of the defence group Babcock audit in 2017 and 2018 (FT 2023c). Moreover, the German regulator Apas fined EY 500,000 euros for its failure in Wirecard audit. This fine is negligible compared to EY's annual revenue figure of 2.3 billion euros in Germany alone (FT2023f). Hence, users argue that the lack of competition in the audit market and the oligopoly status by the Big 4 makes them “Too Big to Fail” and they are still unharmed by the penalties and fines which seem more cosmetic. Regulators cannot afford to have another collapse like Arthur Anderson or having “the Titanic 3” instead of “the Big 4”. The argument is that because the Big 4 audit the majority of the FTSE350 in the UK and similarly in all other big stock exchanges, the non-Big 4 do not have the capacity, resources, technology, scale or enough expertise to audit the big listed clients. This is further complicated by the revolving doors problem, as regulators themselves are sometimes ex Big 4 partners with the potential of regulatory capture (Sikka 2021). For example, KPMG's incident with the PCAOB discussed in Chapter 6.

Auditors on the other hand are arguing that the regulation is getting progressively tougher over the years and that they are also subject to another layer of accountability internally through their internal audit quality review. They believe that given the multiple levels of accountability that their audit quality is in the top level. Unsurprisingly, non-Big 4 auditors agree that the market should become more competitive and the monopoly of the Big 4 should be broken. The argument is that too much work and clients served by the Big 4 given the pressure on audit fees and the time pressure on auditors would ultimately result in lower audit quality. Big 4 auditors think that they are not “Too Big to Fail” citing Arthur Anderson case as a precedent to prove

that no audit firm is too Big to Fail. And the reason they dominate the market is based on the quality of their work and the fact that the non-Big4 lag behind significantly.

Given the views of both the users and auditors, the regulation and market for audit needs to be reformed. This was also the recommendation of the Brydon (2019) and Kingman (2018) reports. The recommendations on how this should be done is discussed in the next section 8.4.

8.3.3 Competence

Users expressed their lack of trust in the competence of auditors when it comes to complex financial instruments and fintech related valuations. This was exacerbated by their concerns of the lack of experience and level of seniority in the audit engagement teams. A concern that auditors in these cases do not have an in-depth understanding of the business that they audit to be able to ask the right questions. Auditors disagree, as they spend huge amount of time doing walkthroughs and understanding the business and whenever they face a complex valuation like fintech derivatives they rely on external experts. Moreover, in each audit team there are significant review process done by the more senior partners, risk management partners and second review partners before auditors are comfortable with their audit opinion. Audit fees, however, represent a challenge as limited audit fees puts pressure on the level of seniority within the audit team, which could be improved by having more appropriate level of audit fees.

8.4 Conclusion and Recommendations

The combined views of the interviewed users and auditors agree that the EAR is a step in the right direction. It represents a significant improvement from the prior binary, black and white, one page audit report where the audit report of an oil and gas company looks the same as that of an airliner without any tailored information about how the auditors arrived at their audit opinion. However, as the analysis of users' interview data revealed in chapter 6, the EAR only achieved legitimacy for auditors' actions as doing the right things but failed to achieve legitimacy for the essence of auditors themselves as being the right social actor for the job. The reasons for such failure expand beyond the EAR to fundamental issues about how the audit profession is structured and its regulation. Furthermore, after analysing the auditors' viewpoint regarding the issues raised by the users as well as their experience in preparing the EAR in chapter 7, it became apparent that there is a perception gap as well as fundamental underlying factors that extends beyond what is included in the audit report. I present below suggested improvements to the audit process that enhances the trustworthiness of auditors as the source of information which would in turn enhance the effectiveness of the EAR as the communication channel of this information. Once these factors are properly addressed trust in auditing can be restored. Without these structural changes all the regulatory reforms would be just cosmetic changes or as what Coffee (2019) describe as "re-arranging the deck chairs on the Titanic".

I present these factors below as the research conclusions and recommendations:

Firstly, the way auditors are hired need to change to regain trust in appearance of auditors as an independent entity. One possibility as users suggested, security regulators could be the one hiring and paying for auditors of companies listed in that stock exchange. This way would assure users that auditors are independent from their auditees as all the interviewed users agreed that they can never see auditors as independent as long as they get paid by their auditee. The audit fees can then be viewed as part of the listing requirements in the stock exchange that

companies need to pay to be listed. This would also benefit the auditors, as auditors do lots of procedures to ensure their independence from the auditees as identified above in section 8.3.1 and in chapter 7 that are usually offset by the lack of users' trust in their independence in appearance. The other possibility is to have a regulatory body or the government to hire the auditors. Or having a governmental body like the National Audit office to conduct the audits of listed companies (Sikka 2021). This was also recommended by the study of Van Brenk et al. (2022) who recommended the establishment of an "Audit Board" a quasi-governmental body that audits PIEs with experienced core permanent staff and temporary fellows from the audit firms who are rotated to ensure independence.

Secondly, the market dominance or Oligopoly of the Big 4 needs to be broken down. However, that does not seem to be a straightforward task. Joint audits can be one of the solutions as suggested in the Brydon report (2019) and the CMA (2019) review, however there are concerns about the division of risks and responsibility and whether it has a meaningful impact on the Big 4 dominance or audit quality. For example, Bédard et al. (2019) study which analysed the mandatory joint audit in France and found it inefficient as audit costs are quite high for the auditees without an increase in the quality of accounting information. Big 4 auditors, argue against joint audits as it can lead to duplication of work and increased costs for companies in terms of time and money (FT 2021). They suggest a cap on the number of FTSE companies audited by the Big 4 (for e.g. 80% of the FTSE 100 instead of 100%). The problem will still exist as non-big 4 firms do not have the resources or the capacity to audit the remaining 20%. Another option is to break down, the big 4 but then given the increase in the M&A activities by companies turning into massive, diversified conglomerates, would make it harder for auditors to have the scale to audit such big conglomerates. So, a possible solution would be for smaller non-big 4 auditors to merge to have the size and scale to increase the competition in the audit market and break the monopoly of the big 4. This would improve the trust in the

accountability of auditors as interviewed users argued that the Big 4 are too big to fail and that the regulators cannot afford to move from big 4 to titanic 3 due to their market dominance and the big gap in resources and scale between the big 4 and the non-big 4.

Thirdly, to improve users' trust in the effectiveness of the regulators on holding auditors accountable, more serious penalties and fines must be imposed on auditors as users believe that current regulators are toothless and ineffective. Given the Brydon review recommendation of establishing a new regulator ARGA, there is an opportunity to regain users' trust in the regulation of the audit industry. And for this to work, more competition is needed as highlighted in the second recommendation above, so regulators can ban audit firms from auditing PIEs if they were found to be negligent in any accounting scandal.

Fourthly, there needs to be more publicity for good high-quality audits. Both interviewed users and auditors agreed that only bad examples get the media attention, and it is not clear how much percentage these bad examples represent out of the total audits performed. And as the analogy was given, that having a negligent physician does not mean all of them are negligent. FRC does publish the results of its audit quality inspections, but most interviewed users were not aware of it. Hence, a more visible way would be as suggested by USR02 is to have a ranking for audit firms based on the quality of their audits as reviewed externally by the FRC or ARGA instead of ranking them by fees or number of staff. However, for this ranking to work structural change identified above needs to be implemented otherwise there would be a bias to the big 4 audit firms, who audit the majority of the PIEs and have more resources in terms of acquiring talents and experts and the scale to afford it compared to the non-big 4 ones.

Fifthly, audit fees represent a critical factor for auditor independence and competence. Having a fair audit fee would ensure that auditors are independent from their auditees and won't have to rely on non-audit services to subsidise auditing. Furthermore, it would allow audit firms to

attract and retain talent and experts for complex transactions and ensuring an appropriate level of seniority in the audit team. Increasing the seniority level in the audit team would also reduce the time pressure on auditors as more experienced senior auditors are more efficient which would also improve the users' trust on the auditor's competence as explained in chapter 6. This is quite important as the increased pressure on auditors in terms of fees and time leads to unintended consequences where the focus shifts to making sure that documentation in the EAR and the audit file is airtight rather than genuinely being sceptical in identifying the auditee's risks.

Sixthly, more frequent audit team rotation not just audit partner rotation as well as audit firm rotation was welcomed by both the interviewed users and auditors to improve auditor independence and professional scepticism. For this recommendation to be implemented successfully, the market for audit need to be ready to have enough audit firms for PIEs to choose from when they tender their audit contracts. Audit firms who can audit big PIEs given the ban of providing non-audit services to audit clients. This would ensure an actual rotation, unlike HSBC and PwC example identified in section 8.3.

Finally, auditing is a social phenomenon and for any of the above recommendations to work, there is a need for a societal agreement about what is an audit. What constitutes audit quality? As Flint (1988, p.14) explains:

“The social machinery for interaction between auditors and audit policy-makers and the relevant interest groups is informal and unstructured, but it is important that it should be effective. A failure on the part of auditors or audit policy-makers to recognise the dynamic nature of auditing or to respond to legitimate societal pressure will result in frustration of the social purpose and the emergence of the kind of 'expectation gap' and misunderstanding”

The perseverance and persistence of the expectations gap as highlighted in chapter 2 is detrimental for the audit function to be successful in regaining its legitimacy. For example, interviewed users do not trust that auditors are independent, and auditors are confident that they are independent, so this perception (expectation) gap needs to be addressed. Once a societal agreement is reached, then and only then the expectations gap would be bridged.

8.5. Research contributions

The thesis contribution to the existing body of knowledge is threefold, empirical, theoretical and policy. It enriches our theoretical and empirical understanding of the impact of the EAR against the backdrop of the mixed theories and the mixed findings of the archival and experimental studies explained in the theoretical framework and the literature review chapters. It moves beyond the methodological blinders and allows the study of the EAR from different perspectives to have a holistic in-depth understanding of how effective is the EAR? This research extends the knowledge and scholarship of the organisational and social context of accounting and auditing research in action, by engaging directly with practitioners. Otherwise, the study of accounting and auditing will exist in as described by Hopwood (1979, page 147): *“a void, within a world grounded in the myths of the accounting mission rather than the achievements of accounting in practice.”* (Hopwood 1979; Power and Gendron 2015).

Moreover, it provides policy implications and recommendation for the regulation of the audit industry.

8.5.1 Empirical Contributions

As discussed in chapter 3, the research to date on the effectiveness of the EAR in the UK and globally is predominantly archival or experimental in nature with mixed findings and many limitations. Hence doing a qualitative field study helps obtain an in-depth understanding of how users perceive the EAR and represents an investment in “knowledge diversification” and “methodological pluralism” which is quite important in a complex process like auditing as Power and Gendron (2015, p. 148) contend:

“Reality is too complex, unstable, and contradictory, and human thought is too fertile and productive to constrain the selection of research methods and orientations through which we choose to approach phenomena like auditing. Alternative viewpoints do not need to compete

against one another in the search for better understandings but can generate complementarities where each new angle generates an incremental increase in our knowledge.”

Moreover, after the introduction of the EAR, to the best of the researcher knowledge, no published academic research to date focused on the auditors’ experience in applying the new report. Interviewing auditors who prepare the EAR allowed me to examine the “organisational reality” of the process of generating the EAR (Power 1995). This resulted in an in-depth analysis which expands our understanding of how the EAR is prepared by the auditors.

8.5.2 Theoretical Contributions

The thesis contributes to the study of auditing as a social practice rather than just a technical practice (Flint 1988). It provides evidence of the shortcoming of the widely used agency theory framework in explaining the failure of EAR to restore trust and legitimacy in auditing. The information asymmetry component is not easily addressed by increasing the information content in the EAR. It is more dependent on whether users trust the auditors themselves as the providers of information in order to be able to trust the information in the EAR. By using Suchman’s (1995) theory of organisational legitimacy and its analytical types to analyse how the EAR achieved legitimacy for auditors’ actions (pragmatic exchange legitimacy, procedural moral legitimacy and cognitive understandability legitimacy) and its failure to achieve legitimacy for auditors’ essence (dispositional pragmatic legitimacy, structural and personal moral legitimacy and cognitive taken for granted legitimacy). Thus, extending the application of Suchman’s 1995 theory of organisational legitimacy into the audit reporting literature.

Furthermore, it extends the literature on the use of Sztompka (1999) social theory of trust in auditing research and its sources to explain why users do not trust the information in the EAR.

Moreover, the thesis extends the usage of the audit comfort framework (Pentland (1993); Carrington and Catusus (2007); and Commerford et al., (2016) in auditing research which responds to Commerford et al., (2016, page 55) call for research:

“Additional use of interpretive qualitative research in auditing. Such an approach may be especially fruitful in understanding how auditing problems are socially constructed. It also is helpful in examining how auditors (as well as regulators and standard setters) understand their roles and approaches to audit work.”

Hence, addressing the relative scarcity identified in the literature of in-depth research with direct engagements with auditors to gain their perspective (Gendron & Spira 2010; Humphrey 2008; Power 2003 and O’Dwyer et al. 2011).

Using the audit comfort framework as the theoretical lens helped to analyse the auditors’ interview data and to analyse the backstage of audit practice and auditors’ organisational reality of producing the EAR. It demonstrates how auditors use their comfort building strategies (relief sense of comfort) to create a state of comfort and move from the discomfort to comfort by producing the EAR as the symbol of comfort that transfer the audit team comfort within the audit firm and externally to the EAR users.

Finally, whilst the research did not address the audit expectations gap directly in the research questions, it contributed to the audit expectations gap literature. As a by-product of answering the research questions and synthesising the users and auditors’ views, it was found that despite the EAR success in providing the information needed by the users, it failed to reduce the information gap component of the expectations gap as users do not trust this information. The information gap is not just about the information included in the audit report, it extends beyond the EAR to auditors as the preparers of the EAR and whether users trust them, to be able to trust the information they provide. By synthesising the views of the users and auditors in terms

of the reasons behind the users' lack of trust in the information in the EAR in particular and the audit profession in general it offered users and auditors' suggestions for improvements to bridge this gap.

8.5.3 Policy Contributions

The findings of this research provide useful insights for the regulators and audit policy makers in the UK, about the effectiveness of the EAR and where it succeeded in repairing the legitimacy in auditors' actions and failed in achieving the legitimacy of auditors' essence as the right social actor for the job. Furthermore, the reasons behind this failure and the reasons behind the lack of users' trust in auditors. It highlights the strengths of the EAR and provide users' and auditors' suggestions for improving its shortcomings. And as explained in section 8.4 the recommendations of the thesis go beyond the EAR to include structural changes to the audit industry to restore its legitimacy and improve its effectiveness. These structural changes are essential to rebuild users' trust in auditors and the audit industry. Once they changes are implemented, the EAR can achieve its intended outcome. Furthermore, as a result of the similarity between the UK extended audit report and the IAASB standard ISA 701 which require the disclosure of Key Audit Matters (KAM's) the findings would be useful to other countries applying the IAASB new standard. (IASSB 2015) Additionally, it would add insights to the US version of the extended audit report where Critical Audit Matters (CAMs) required by the PCAOB AS 3101 standard for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after Dec. 15, 2020 for all other companies (PCAOB 2016), which represents the US version of risks of material misstatements found in the UK report.

8. 6 Research Limitations:

In order to address the first and second research questions, primary interview data needed to be collected from the users of the EAR. The term users is very broad and involves a big diverse group of stakeholders (investors, creditors, trade unions, governments, regulators, the society... etc.). Given the limitation on the number of interviews that can be conducted, I followed the conceptual framework of financial reporting (IASB) in focusing on the primary users as current and potential investors (or shareholders) who invest in UK listed companies that are subject to the EAR standard. This represents the research population relating to the first and second research question. The researcher acknowledges, this selection as one of the research limitations and provide an opportunity for future research to capture the views of the other users of the EAR. Similarly, to address the third research question, the interviewed auditors had an average of 10 years of experience and none of them was at a signing partner level, so the results might have been different if the interviews were conducted with signing partners, so this represents a limitation and an area for future research.

Furthermore, as indicated in chapter 5, convenience non-probabilistic sampling technique from the researcher network, followed by snowball sampling was used by the researcher from the networks of the researcher's networks. The reason behind these sampling techniques, is to make sure that knowledgeable participants are recruited and to overcome interview access obstacles (Bryman and Bell 2015). So, the researcher made subjective judgement in the sample selection while adhering to the targeted characteristics of the interviewees and following a due ethical process.

Moreover, the field study using semi-structured interviews has its own limitations, as the knowledge production through the PhD thesis is the researcher's interpretation of the social reality rather than the social reality itself (Ryan et al. 2002). That is the reason the researcher included full lengthy original interviewees' quotes in chapters 6 and 7 instead of paraphrasing

them, so that readers can have their own interpretations and compare it to those of the researcher. The researcher's background as an external auditor may influence the research process but given the nature of interpretivist qualitative research, subjectivity is not viewed as a limitation but in fact is acknowledged and celebrated and considered one of the hallmarks of the research (Braun and Clarke 2022).

Additionally, there is a risk that some of the interviewees may not be completely honest, withhold information or tell the researcher what he wants to hear (Turley 2004). Given the researcher's interactions and the rich data and findings of the research it seems unlikely. Another risk relates to misinterpretation of the interviewees' responses, and to mitigate this risk, the researcher asked the interviewees questions to double check and summarise his understanding of their responses and audio recordings were used to ensure the reliability of the transcription process.

Eventually the temporal nature of the data collection where the semi-structured interviews were conducted from 2020 till 2022 represents a limitation. As the auditing landscape is under huge scrutiny and the policy changes are still under review given the Kingman, CMA, Brydon and government white paper reviews. Further research following the implementation of these changes is needed to follow up on their impact on the users and prepares of the EAR.

8.7 Areas for future Research:

As explained in the limitations section 8.6, future research may consider interviewing important stakeholders and users of the EAR who were not covered in this research would improve our understanding of the effectiveness of the EAR for these equally important stakeholders. Similarly, interviewing signing partners to reflect on their experience of preparing the EAR and their views on the users' reasons for lack of trust would complement

the research findings from less senior auditors. Given the different incentives, fees pressure and revenue targets for the signing partners.

Moreover, future interpretivist research, interviewing regulators (the FRC or potentially the ARGA) to hear their side of the story and their reflection on the lack of users' trust in their oversight for auditor's accountability is important to obtain a holistic in-depth understanding from all the parties involved with the EAR.

Future research may also be conducted in different institutional settings to compare and contrast the shareholder centric, common law UK model with different institutional setting in continental Europe in countries like Germany for example with more stakeholders focus and code law legal system when it comes to the EAR. Similarly, research on other developing countries who have less developed capital markets and different legal infrastructure would provide useful insights to the global impact of the EAR on its users and preparers.

Moreover, the findings of the research can be the inductive foundation of large-scale quantitative studies on the EAR, independence, audit fees, auditor rotation and litigation costs.

Eventually, once the recommendations of the government white paper and the Brydon and Kingsman reviews are implemented and the new regulator ARGA is established and functioning a follow up research on this development would address the temporal limitation of the PhD thesis.

8.8 Concluding Thoughts:

I have started this long PhD journey back in 2015 just after the introduction and application of the new audit reporting standard that require the adoption of EAR for UK PIEs with curiosity about whether this new EAR would make any difference. I thought it represents an excellent research opportunity given the possibility of having a before and after comparison or what is known quantitatively as a difference in difference research design. I started by analysing the academic literature covering the EAR and was surprised by the prevalence of archival capital market research, especially with the huge limitation that both the EAR and the annual report are published at the same time with any impact on the proxies for informativeness adopted by these papers could be attributed to information in the annual report and not necessarily the EAR. Simultaneously, I was doing my core training module in qualitative research methods and in a lecture by Professor Phil Johnson about research philosophies he was emphasising the importance of “verstehen” characteristic of qualitative research in management versus the more positivist characteristic of “erklären”. I was encouraged to explore more the qualitative route to auditing research especially given by the shortage of qualitative interpretivist studies on the impact of the EAR. I subsequently attended a workshop by Professor Yves Gendron about the qualitative research in accounting and auditing which further convince me that this is the research method that fits with my beliefs about reality and how knowledge is created. An interpretivist qualitative field study was well suited to my research questions as this approach enabled me to explore and analyse auditing as a social phenomenon through conducting semi-structured interviews with the users and the preparers of the EAR. The interview data was quite rich and informed my choice of theoretical lens by going back and forth between the data and the theories to develop a theoretically informed, in-depth understanding of the EAR and address the research questions. The research journey in the past 8 years have been challenging

but at the same time rewarding conceptually which allowed me to grow my research skills and whet my appetite for qualitative interpretivist research in auditing beyond the PhD.

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Appendices:

Appendix 1: Participant Consent Form and Participant Information Sheet

Participant Consent Form

Title of Project: **The UK Extended Audit Report: Is Bigger always Better? A field study of users' and auditors' experience.**

Name of Researcher: **Mostafa Abuzeid**

Participant Identification Number for this project:

Please tick box

1. I confirm that I have read and understand the information sheet dated May 2020 for the above project and have had the opportunity to ask questions. ☐
2. I understand that my participation is voluntary and that I am free to withdraw at any time without giving any reason. (Mostafa Abuzeid: 0114-222-3481) ☐
3. I understand that my responses will be anonymised before analysis. I give permission for members of the research team to have access to my anonymised responses. ☐
4. I agree to take part in the above research project. ☐
5. I agree to an audio recording of the interview being made. ☐

Name of Participant

Date

Signature

Name of Lead Researcher

Date

Signature

To be signed and dated in presence of the participant

Copies:

Once this has been signed by all parties the participant should receive a copy of the signed and dated participant consent form, the letter/pre-written script/information sheet and any other written information provided to the participants. A copy for the signed and dated consent form should be placed in the project's main record (e.g. a site file), which must be kept in a secure location.

Research Participant Information Sheet

Project Title:

The UK Extended Audit Report: Is Bigger always Better? A field study of users' and auditors' experience.

Invitation: You are being invited to take part in a research study. This research is a part of a PhD project at the University of Sheffield carried out by Mostafa Abuzeid. Participation in the project is entirely voluntary. Before you decide it is important for you to understand why the research is being done and what it will involve. Please take the time to read the following information carefully and discuss it with others, if you wish. Please ask Mostafa Abuzeid (contact details are at the end of this document) if there is anything you are unsure about, or if you would like further information.

The Study: The UK Financial Reporting Council (FRC) was the first to implement the new extended audit report by introducing International Standard on Auditing (ISA) 700 (UK and Ireland). Auditors of companies subject to the UK code of corporate governance from periods commencing on or after 1 October 2012 have to prepare the extended audit report. This update represents a shift from the traditional short form binary pass/fail one page audit report to multiple pages report, where the auditor reports on key audit matters including the assessed risks of material misstatements that had the greatest impact on the audit, the materiality levels, and the scope of the audit given the materiality levels and the assessed risks of material misstatements. The main aim of this update is to increase the informativeness and value relevance of the audit report, and hence reduce the information gap component of the audit expectations gap and restore public trust. (FRC 2013) The aim of this research is to capture the experience of primary users and preparers of the new UK extended audit report and to test its informativeness and effectiveness in order to inform the regulators and provide suggestions for improvement.

Your involvement, should you agree to take part: As a user/preparer of the UK extended audit report you are invited to participate in the study so that your professional views can be obtained.

You will be interviewed by Mostafa Abuzeid; this should last between **30 – 60 minutes**. You will also be asked if you agree to the interview being recorded on a voice recorder or a similar device. This is necessary to allow the researcher to transcribe the interview and analyse it at a later date. If you agree to this, you may still ask for the recorder to be switched off at any time during the interview. After the interview, you will be invited by email to complete a questionnaire survey.

Confidentiality and Anonymity: At no point will your identity be revealed to anyone other than the academic team involved in this PhD project. This team comprises of Professor Jim Haslam (PhD Supervisor, University of Sheffield), Professor Sumon Bhaumik (PhD Supervisor, University of Sheffield) and Mostafa Abuzeid. All notes and audio records will be kept in secure storage and used in accordance with the General Data Protection Regulation (GDPR). No identifying information will be supplied to a third party. The findings will be anonymised and any identifying information stated during the interview will be changed to make it anonymous.

Furthermore, in accordance with GDPR, this research is being carried out as a specific task in the public interest.

What will happen to the results of the research study?

The research will be written up with the intention of being published in academic peer reviewed journals, but always on the basis of the provisos given.

For further details or questions, contact:

Researcher:

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Appendix 2: Sample UK Audit Reports:

UK Audit Report in 1895:

According to PwC (2015, page 3), back in the 1800's the audit report was less than 50 words.

A sample audit report of this period:

“We have to report that we have examined the above Balance Sheet with the Accounts and Vouchers relating thereto at... and with the Accounts received from Branches and certify the same to be correct. We have verified the Balance of Cash at Bankers and in hand.

Signed, A. N. Accountant London: 26th February 1895”

UK Audit Report in 1980's:

Audit report proposed by the 1980 APC audit reporting standard FRC (2007, page 10):

“We have audited the financial statements on pages ... to ... in accordance with approved Auditing Standards.

In our opinion the financial statements, [which have been prepared under the historical cost convention as modified by the revaluation of land and buildings], give a true and fair view of the state of the company's affairs at 31st December 19... and of its profit and source of application of funds for the year then ended and comply with the Companies Act 1948 and 1967”

Innes et al. (1997) provided an example of the short form audit report:

“Auditors’ report to the members of X Company Limited

We have audited the financial statements on pages ... to ... in accordance with approved auditing standards. In our opinion, the financial statements give a true and fair view of the

state of the company's affairs at 30 April 19... and of its profit and source and application of funds for the year then ended and comply with the Companies Act 1985."

UK Expanded Audit Report in 1990's:

Also Innes et al. (1997) provided an example for SAS 600 wording for the expanded audit report:

"auditors' report to the shareholders of X Company Limited

We have audited the financial statements on pages ... to ... which have been prepared under the historical cost convention and the accounting policies set out on page

Respective responsibilities of directors and auditors. As described on page ... the company's directors are responsible for the preparation of financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

Basis of opinion. We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion. In our opinion the financial statements give a true and fair view of the state of the company's affairs as at 31 December 19. . and of its profit for the year then ended and have been properly prepared in accordance with the Companies Act 1985."

The UK Extended Audit Report in 2013:

FRC (2015, page 66) provided a pro-forma illustrative extended audit report:

"INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF XYZ PLC

We have audited the group financial statements of (name of company) for the year ended ... which comprise [specify the titles of the primary statements such as the Group Statement of Financial Position, the Group Statement of Comprehensive Income, the Group Statement of Cash Flows, the Group Statement of Changes in Equity]⁸ and the related notes⁹. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement [set out [on page ...]], the directors are responsible for the preparation of the group financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the group financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's [(APB's)] Ethical Standards for Auditors.

Scope of the audit of the financial statements

Either:

A description of the scope of an audit of financial statements is [provided on the FRC's website at

www.frc.org.uk/auditscopeukprivate] / [set out [on page ...] of the Annual Report].

Or:

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the [describe the Annual Report] to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the group financial statements:

- give a true and fair view of the state of the group's affairs as at and of its profit [loss] for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

Our assessment of risks of material misstatement

[Insert a description of those specific assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the audit strategy; the allocation

of resources in the audit; and directing the efforts of the engagement team.]

Our application of materiality

[Insert an explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole.]

An overview of the scope of our audit

[Insert an overview of the scope of the audit, including an explanation of how the scope addressed the assessed risks of material misstatement and was influenced by the auditor's application of materiality.]

[The disclosures about the above three matters are made in a manner that complements the description of significant issues relating to the financial statements required to be set out in the separate section of the Annual Report describing the work of the Audit Committee in discharging its responsibilities (see paragraphs [19B] and A13D] of ISA (UK and Ireland) 700).

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Strategic Report and the Directors' Report for the financial year for which the group financial statements are prepared is consistent with the group financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the ISAs (UK and Ireland), we are required to report to you if, in our opinion, information in the Annual Report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of

the Group acquired in the course of performing our audit; or

- is otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the Annual Report is fair, balanced and understandable and whether the Annual Report appropriately discloses those matters that we communicated to the Audit Committee which we consider should have been disclosed.

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the directors' statement, [set out [on page...]], in relation to going concern; and
- the part of the Corporate Governance Statement relating to the company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review.

Other matters

We have reported separately on the parent company financial statements of (name of company) for the year ended ... and on the information in the Directors' Remuneration Report that is described as having been audited. [That report includes an emphasis of matter] [The opinion in that report is (qualified)/(an adverse opinion)/(a disclaimer of opinion)].

[Signature]

Address

John Smith (Senior statutory auditor) Date

for and on behalf of ABC LLP, Statutory Auditor"

Appendix 3: Semi-Structured interview questions:

Generic Semi-Structured Interview Questions for Users of the EAR:

• In what role do you use the annual accounts and the related audit report?
• How many years have you been in this role?
• In your opinion, what is the role and responsibility of the external statutory auditor?
• How useful is this role for you on a scale from 0 to 10 (Where 0 = not at all useful and 10 = extremely useful)?
• Has your opinion changed over time? (Yes/No) And why is this the case?
• In your opinion who are the primary users to whom auditors should be accountable? What about the other users?
• In your opinion, what additional responsibilities should be assumed by the auditor?
• What is your level of trust in the process of Auditing on a scale from 0 to 10 (Where 0 = no trust at all and 10 = highly trust it)? Specifically, elaborating on your level of trust of the following: a) Regulators b) Standards c) Independence of Auditors
• Did your opinion about the trustworthiness of the auditing process change over time? (Yes/No) And what are the reasons for this?
• What factors could improve the trustworthiness of the auditing process?
• What is your level of trust in the current technical knowledge and financial expertise of auditors on a scale from 0 to 10 (Where 0 = no trust at all and 10 = highly trust it)? , given the responsibilities assumed by auditors under existing standards and regulations?
• Did your opinion about the technical competence of auditors change over time? (Yes/No) And what are the reasons for this?
• What factors could improve the technical competence of auditors?
• What are your information needs from the auditors of the company?
• Compared to the old short form audit report, is the new audit report more informative? (Yes/No) And what are the reasons for this?

On a scale from 0 to 10 (where 0 is uninformative and 10 is highly informative) how do you assess the information content in terms of auditors' assessment of Key Audit Matters (KAM's) and the responses made to address them in the EAR?
In your opinion, does the audit report contain new information about the company not available from other sources? If yes, in what areas?
In your opinion on a scale from 0 to 10 (where 0 is very generic and 10 is highly tailored), how tailored are the risks of material misstatements included in the audit report to each company? And why do you think this is the case?
What is the impact of the disclosure of auditors' materiality thresholds on your assessment of Audit Quality?
What is the impact of the disclosure of auditors' scope given KAM's on your assessment of Audit Quality?
What additional disclosures by the auditors other than those included in the extended report would you be interested in?
In your opinion, has there been an improvement in the subsequent financial statements disclosures to which reference was made in the auditor's KAM's? (Yes/No) Why do you think this is the case?
What is the impact of the disclosed risks of material misstatements on your assessment of the quality of the company's annual accounts?

Generic Semi-Structured Interview Questions for Auditors (preparers of the EAR):

Questions
• How many years have you been in your role?
• What is your industry specialization?
• In your opinion, what is the role and responsibility of the external statutory auditor?
• In your opinion who is the primary users, auditors should be accountable to? What about the other users?
• Based on your experience, what is your assessment of the organisational independence of auditors in terms of non-audit fees and audit tenure on a scale from 0 to 10? (where 0 is highly dependent on auditee and 10 is highly independent from auditee) Why is this the case?
• What is your assessment of the operational independence of Auditors on the auditee in terms of fieldwork accumulation of audit evidence on a scale from 0 to 10? (where 0 is highly dependent on auditee and 10 is highly independent from auditee) Why is this the case?
• What do you suggest to improve auditor independence?
• Compared to the old short form audit report, is the new audit report more informative? (Yes/No) And what are the reasons for this?
• On a scale from 0 to 10 (where 0 is uninformative and 10 is highly informative) how do you assess the information content of the EAR? And why do you think this is the case?
• What additional disclosures, other than those included in the EAR, would improve the informational value of the audit report?
• Do you think that the extent of audit work is reflected in the audit report?
• What are the practical challenges of applying the new audit reporting standard ISA 700 (UK & Ireland)?
• What is the impact of the disclosed risks of material misstatements on the potential litigation costs?
• In your opinion do the benefits of the new audit report exceed the costs?
• Under what conditions would the auditors be willing to increase the level of assurance provided in the annual statutory audit?
• In your opinion, has there been an improvement in the subsequent accounting processes, controls or policies to which reference was made in the auditor's KAM's? (Yes/No) Why do you think this is the case?