

Perceptions of Unqualified Statutory Audit Reports: The Case in Malta

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Abstract

In this paper we lay out the results of a study on the perceptions of three Maltese stakeholder groups, namely external auditors, financial advisers and bank lending officers, pertaining to the communication and information aspects of the recently revised audit reporting standards. To do this we adopted a two phase sequential mixed-method approach using a questionnaire which was first distributed to the three stakeholder groups. Subsequently, the quantitative data collected in the first phase was analysed and discussed in semi-structured interviews conducted with a sample of twelve participants. Findings indicate that the most important section in the unqualified audit report is by far the auditor's opinion. This is because it helps users determine the reliance that they can place on an entity's accompanying financial statements when making financial decisions. However, users proved sceptical on the clarity of the unqualified audit report's message and the technical jargon contained therein. This is primarily due to the users' lack of understanding of the scope of the audit, its intended objectives and the technical jargon incorporated in the report.

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INTRODUCTION

Today's complex business environment has stimulated the users' need for sound entity information upon which they ought to base their financial decisions (IAASB, 2011). The main source of an entity's financial information lies within its financial statements. An external auditor is typically engaged to conduct a statutory audit to ascertain the credibility of this financial information (IOSCO, 2009). In Malta, the Income Tax Management Act 2014 (Art. 19) requires all locally registered companies, irrespective of their size to conduct a full scope statutory audit based on International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB). According to these standards, after an audit is completed, the auditor should express an independent opinion on an entity's financial statements in an audit report (AR) (Boolaky and Quick, 2016). If the auditor has gathered sufficient evidence to conclude that "the financial statements as a whole are free from material misstatement" an unmodified audit opinion issued, and communicated in the Unqualified Audit Report (UAR) (IAASB, 2015b, par.11).

Studies recognise stakeholders' need for more information pertinent to the entity under scrutiny since the standardisation of financial reporting limits the information which the auditor can communicate on the audit and its resulting conclusions (Coram et al., 2011). This precludes stakeholders from conducting a thorough review of an AR's contents, particularly the audit report section (Gray et al., 2011), with the recent series of corporate scandals escalating this issue further. The IAASB (2011) itself had recognised the limited scope of an AR as merely discussing the conclusion from the audit and its usefulness to stakeholders, coining the term Information Gap.

Other studies have shown that there are instances where the value of an audit report may be reduced where its key message is not understood as intended; widespread gaps were reported amongst auditors and users, even with users who are considered to be more sophisticated (Mock et al., 2009). Distinct interpretations were also held by auditors and users for the different technical jargon and concepts contained in an audit report, with

gaps in perceptions also emerging amongst the various users themselves, extending beyond the more obvious auditor-user gaps (Asare and Wright, 2012). Researchers have termed this as the Communication Gap – these and other shortcomings prompted the main auditing standard-setting bodies to place the AR's reform at the top of their agenda, with fundamental enhancements implemented in 2015. Given its recent introduction, and the lack of research performed in a small-island state, it was considered appropriate to study local stakeholders' perceptions on how the AR is communicating its primary message, and whether the information contained in this report enhances its value. The communication and information aspects of the unqualified audit report (UAR) are the primary focus of this study.

Furthermore, this paper aims to understand the perceptions of three key Maltese stakeholder groups, namely auditors, bank lending officers and financial advisers, to the revised UAR. The study assesses their perceptions of the UAR's communicative aspect and the adequacy of information contained in it. The study also investigates the auditor-user gaps, and perception gaps between the two user groups themselves, and finally potential gaps amongst all three stakeholders.

Overall, this study seeks, within the context of an island-state (Malta), to: ascertain stakeholders' overall perceptions of the UAR, pertaining to the aspects of Communication and Information; investigate differences in these perceptions between the three selected groups; and establish the stakeholders' views on potential means to mitigate the Communication and Information Gap in the future.

The rest of the paper is divided into four main sections. The next section discusses the major changes to the audit report over the years, and the key results from previous studies which investigated the UAR's communication and information gaps. This is followed by the third section which discusses the methodology used in this study. The fourth section provides a summary of the results pertaining to the statistical and qualitative methods adopted. The final section presents the main findings and conclusions.

LITERATURE

Early Changes to the Unqualified Audit Report

Audit reporting has been a matter of considerable debate ever since the twentieth century. Improvements were made over the years, but the scope remained relatively unchanged, which is that of giving an opinion on whether the figures in the financial statements were true and fair. The content also remained fairly stable with the main sections being the “title”, “opinion” and “scope” paragraphs (Church, Davis and McCracken, 2008; Coram, 2014). The first major enhancement aimed at addressing the Audit Expectations Gap (AEG) was SAS 58, introduced in the 1980's, which explained the core audit concepts and the different roles of management and auditors. Whilst subsequent studies revealed evidence of enhanced user perceptions following this amendment (e.g. Kelly and Mohrweis, 1989, as cited by Gray et al. 2011; Miller, Reed and Strawser, 1993), others continued to report widespread gaps amongst the perceptions of users and auditors alike (e.g. Hatherly, Innes and Brown, 1991; McEnroe and Martens, 2001).

International Standard on Auditing (ISA) 700, coming into effect for ARs' dated on or after 1 December 2006 (IAASB, 2006), was aimed at increasing the amount of information provided to financial statement users in the AR. However, despite this standard's inclusion of more detailed explanations on the auditor's responsibilities and that the audit evidence obtained is sufficient and appropriate to provide a basis for an audit opinion, the AR retained its standardised format. Since the change merely increased the boilerplate explanations, this standard had an insignificant effect on both non-sophisticated and sophisticated users' perceptions (Chong and Pflugrath, 2008; Coram et al. 2011).

Recent Criticisms: The Information Gap

The collapse of Enron in 2008 and the demise of their external auditors Arthur Anderson, caused a strain on the auditor's role as a reliable intermediary and a point of communication with the entity's stakeholders (Soltani, 2007; IAASB, 2012, p.1). The catastrophic events of this financial crisis induced stakeholders across the globe to

demand additional disclosures by auditors on audit findings, including information about the entity under scrutiny and its financial statements (IAASB, 2012). Although the basic premise of an audit is to reduce agency costs, information asymmetries between the agents and principals still existed. Users acknowledged that the information disclosed to them is a small section of a wider net of information accessible to both an entity's management and its auditors. This is termed as an Information Gap, or

[...] a gap between the information they [users] believe is needed to make informed investment and fiduciary decisions, and what is available to them through the entity's audited FS or other publicly available information (IAASB, 2011, p.8).

According to the IAASB (2011), the absence of disclosures which are necessary for users to understand key information about the financial reporting process and the audit conducted, result in an Information Gap. The standard-setting body sought to address this issue and the AEG by increasing the information which auditors would be mandated to disclose in the AR. Although certain information must be provided by management, the IAASB (2011) recognised that auditor insight on certain matters would be of particular relevance to users.

After extensive debates, the IAASB issued ISA 700 (Revised) in 2015, the main standard dealing with the AR, an overview of which is provided in Table 1. The revision intended to meet the needs of financial statement users by improving both the communication and information value of the AR, whilst restoring trust in the audit and accompanying financial statements.

Key Audit Matters

Although auditors following ISAs are now required for the first time to supplement the AR with their own information, in France, auditors have been obliged to provide additional disclosures ever since 2003, referred to as Justification of Assessments (JOAs) (IAASB, 2015b). Despite this section's ability to enhance the report's communicative value, capital-markets did not particularly react to these additional disclosures, possibly because users: [i] did not understand the

technical jargon utilised; [ii] there was an information overload; or [iii] these reports used boilerplate statements. As a result, auditors in France resorted to disclosing standardised JOAs, ultimately thwarting their original intended purpose (Footprint Consultants, 2011).

Mock et al. (2012) originally suggested that additional information would enhance the AR's communicative value. However, additional detail is not always beneficial as it may result in information overload (Vanstraelen et al., 2012). A longer AR may deter stakeholders from reading the complete report, given the limited time users, particularly those classed as sophisticated, allocate to this section (Church, Davis and McCracken, 2008; Vanstraelen, *et al.*, 2012).

Although the inclusion of KAMs in the UAR was aimed at reducing information asymmetries between users and auditors, Boolaky and Quick's study (2016) showed that when bank directors were given information on KAMs, their decision on whether credit should be granted to their customers did not differ in situations where no KAMs were disclosed in the FS. Additionally, information asymmetries may persist even with disclosure of KAMs, since Cade and Hodge (2014) revealed how management may be less inclined to communicate openly with their auditors, suggesting that the auditors' requirement to disclose KAMs may adversely impact the fundamental auditor-client relationship.

Audit Engagement Partner's Name Disclosure

The IAASB sought to improve transparency and accountability in the AR by requiring engagement partners to sign their name at the end of the report. However, auditor interviewees in Vanstraelen *et al.* (2012) had previously argued how engagement team information may not be particularly value-adding to users. Trpeska, Atanasovski and Bozinovska's (2017) quantitative study among 114 Macedonian lending officers demonstrated the lack of added value in having such information in the report. Similarly, financial analyst interviewees in Vanstraelen *et al.* (2012) considered audit firm information to be already enough and no further information about the partner responsible for the engagement was necessary.

Affirmative Statement on Independence and Ethical Responsibilities

This is another newly introduced section, presented under the 'Basis for Opinion' paragraph in the UAR (IAASB, 2015a). Lending officers in Trpeska, Atanasovski and Bozinovska's (2017) study had considered this to be amongst the least significant changes effected in the report. Indeed, auditor interviewees in Vanstraelen *et al.* (2012) discussed how users are inclined to overlook independence information since they may be more interested in reviewing, for instance, critical risk areas.

Enhanced Description of Audit Responsibilities

When the retention of auditor responsibilities information in the AR was questioned after the financial crisis, the Chartered Financial Analyst Institute's (2010) survey exhibited how most respondents emphasised the importance of retaining this section in the report since it is key to highlighting the limitations of an audit. Therefore, the IAASB (2011) sought to enhance this section. However, according to Cordos and Fulöp's (2015) study, this amendment was less useful when compared to KAMs. Although user interviewees do not see any added value in receiving this type of information, this section is required to safeguard auditors in the event of litigation (Vanstraelen *et al.*, 2012).

The Communication Gap

Communication of the Key Message

Communication of the auditor's work is a key aspect of the financial reporting process (Coram et al., 2011). The sole means of communication available to the auditor is through the AR. A Communication Gap was created from "[...] differences between what users desire and understand and what is communicated by the assurance providers" (Duncan and Moriarty, 1998; Mock et al., 2012). The main purpose of an UAR is to provide confidence on the financial statements' conformity to a set of relevant accounting criteria (ICAEW, 2013). As companies evolved, so have the interests of their stakeholders, resulting in a shift towards reporting of non-financial information, such as strategy or risk (Haddrill, 2011; Asare and Wright, 2012). Asare and Wright (2012) report

how user interpretations could have been likewise influenced to shift accordingly, with evidence showing that at times, certain users have misinterpreted an unqualified opinion as a sign that a company is properly managed; a sound investment and able to meet its strategic goals.

The quantitative study by Asare and Wright (2012) in the United States (U.S.) with 43 non-sophisticated investors, 33 bankers and 78 auditors, reports high confidence attributed by lenders to the aforementioned factors when presented with an UAR, versus auditors who attributed a lower confidence, therefore resulting in a gap in perception between these two groups. Conversely, the focus group participants in Gray et al. (2011) revealed opposite results, with participants agreeing that the information in the UAR does not aim to answer any questions on the above mentioned three factors. Indeed, auditing standards assert how an UAR is not intended to provide any sort of confidence on these three elements, since entities are bound to receive an unqualified opinion as long as their financial statements are fairly presented (Asare and Wright, 2012). However, Asare and Wright (2012) argue that since the AR does not explicitly state anything on these factors, it still provides information on them: “by omission, creating room for opportunistic interpretation” (p.201).

The AR is a key tool for stakeholders when taking decisions on an entity (Mautz and Sharaf, 1961). The questionnaire study conducted by Duréndez Gómez-Guillamón (2003) with 112 Spanish credit institutions and brokering companies reports evidence of both groups assigning a high level of usefulness to the AR for their financial decisions. A later study by the CFA Institute (2010) showed how most analysts recognised the prominence of an AR in assisting investment decisions, yet some stressed how its boilerplate text may restrict its value added. Indeed, the focus group results by Gray et al. (2011) reveal how despite its importance, most users do not read the report, whilst auditors did not presume they do; readers simply refer to the opinion section and the name of the firm performing the audit. The standardised text usually incorporated in it, discourages readers from reading it thoroughly (Mock et al., 2012).

As a result, the IAASB (2011) sought to reaffirm the AR’s purpose for facilitating decision-making through the reform. Indeed, after ISA 700’s revision, Trpeska, Atanasovski and Bozinovska (2017) report how Macedonian lending officers viewed the AR as valuable, regardless of the opinion issued. However, it is also important to consider how certain users, particularly sophisticated ones, are in a position where they can demand additional entity-information, or can resort to other sources of information available to them on top of the AR, to assist in their analysis.

Vanstraelen et al. (2012) argued that such discrepancies in perceptions may be explained by the unresolved AEG, where those who do not understand the audit profession cannot be expected to understand its communications. Additionally, certain accounting concepts are complex and those outside the profession may find these challenging to decipher, even individuals with a reasonable level of business knowledge (CFA Institute, 2010; IASB, 2010). Scott (1994) explained these dissimilarities through reader-response theory, where different interpretations of the same text can be expected since individuals may hold distinct backgrounds, motives and expertise.

Determining those elements which may be contributing to a Communication Gap is imperative, since this can lead to misinformed users, unintended investments and reduced confidence in the audit profession (Asare and Wright, 2012). Failure for auditors to properly communicate with stakeholders can prompt the latter to question the value of audits. Addressing any gaps in communication amid auditors and users can help ensure stakeholders’ interests are safeguarded (Turner et al., 2010).

Communication of Technical Terminology

The IAASB (2011) highlighted the following terms found in the AR as being particularly subject to misinterpretation: ‘Materiality’, ‘Reasonable Assurance’, ‘Fairly Present’ and ‘True and Fair View’, amongst others. The Commission on Auditor’s Responsibilities (1978) had already called for the elimination of such jargon, recognising how these may result in different interpretations by AR readers. Despite suggesting how these terms should either be replaced or thoroughly explained, the

IAASB (2011) has yet to make a move towards their elimination.

In the 2015 reform, an explanation for the term 'Reasonable Assurance' was introduced, being explained as: "a high level of assurance" (IAASB, 2015a, par.37). Without any explicit quantification, Asare and Wright (2012, p.203) suggest that this high-level definition "leaves a lot to the imagination". Indeed, previous studies had shown that whereas on average, auditors obtain 76.34% assurance that the financial statements are in accordance with an applicable financial framework, lenders overestimated this to be at a 91.94% level (Asare and Wright, 2012). Although this suggests undue reliance by lenders, it is noteworthy to highlight that there was no presumption about an audit providing absolute assurance.

'Materiality' is another term which has been exposed to potential misinterpretation as this is solely determined through the auditor's own professional judgement. Focus group discussions by Gray et al. (2011) revealed how different participants interpreted 'Materiality' differently. According to Asare and Wright (2012) such distinct interpretations stem from the absence of mandated materiality disclosures in an AR. Materiality levels are not understandable from merely reading the report and even if users had to extensively search through auditing standards, no conclusion could be reached on what this term is intended to communicate. Nevertheless, when Demanuele (2016) explored the prospect of introducing materiality disclosures in Malta, it was concluded that due to the small size of the Maltese market, the shortcomings that would arise from including such information in the AR would outweigh any potential benefits.

When expressing an unmodified opinion, auditors can make use of two phrases, either "present fairly, in all material aspects" or "give a true and fair view" (IAASB, 2015a, par.25). It is customary for the former sentence to be used in the U.S., whereas the latter in the UK and EU countries (McEnroe and Martens, 1998). McEnroe and Martens' (1998) study reports that when presented with the sentence "present fairly in conformity with GAAP", auditors and investors believed that other than fair presentation with general applicable accounting principles, the word

'fairly' also implied that what is being presented, is being done in a non-misleading manner.

Additionally, although other terms were recognised by the IAASB (2011, p.12) as "lacking a common meaning", apart from "Reasonable Assurance", to-date the UAR provides no clarification for the remaining technical jargon.

METHODS

To do this we adopt a sequential two phase mixed method approach, starting with a quantitative data collection, whilst building upon and explaining the quantitative findings, using qualitative techniques (Creswell and Clark, 2007). The initial data collection stage consisted of a web-administered survey. The survey incorporated a set of closed-ended questions, with most questions requesting participants to specify their level of agreement or importance to the statements presented, using a five-point Likert scale. All participants were contacted through the generic email of the entity they were employed with, and a request was made for the survey to be circulated to employees who fit the study's description. To increase participant response rates, hard copies of the questionnaire were also distributed.

The population selected for this study included all Maltese audit firms, financial advice firms and banks offering corporate lending facilities in Malta. Out of a total of approximately 2,000 possible participants, a response from 219 participants was attained, therefore resulting in a maximum 6.25% margin of error, assuming a 95% confidence level. The responses were analysed through a series of *Chi-Square*, *Friedman* and *Kruskal-Wallis Tests* using IBM SPSS version 23.

This analysis was followed up by several semi-structured interviews with a selected number of survey respondents. The chosen interviewees consisted of six auditors (two auditors from Big-Four firms, two auditors from medium-sized firms and two sole practitioners), three senior bank lending officers and three established financial advisers. This allowed the researcher to corroborate the results of the survey and obtain a deeper insight into participants' perceptions and thoughts.

RESULTS AND DISCUSSION

Sections in an Unqualified Audit Report

The Auditor's Opinion

Table 2 below shows that the auditor's opinion section ranked as the most important one across all participants. This was somewhat expected given that the audit opinion contains the pivotal message in the report. Another element which readers focused on was the key audit matters and the audit firm performing the audit. This is in line with Gray *et al.* (2011) whose focus group discussions revealed that users largely refer to the opinion and audit firm information, given the amount of standardisation in the report. Most user interviewees (5/6) agreed with this result, advising that an audit performed by a strong and reputable firm provided an even higher level of confidence than is typically placed on the audit opinion.

Sections other than the Audit Opinion

In Table 3, users assessed the 'Importance of Sections other than the Audit Opinion'. The Kruskal-Wallis results show that auditors agreed that the UAR communicates a clear message, and that its contents are understandable. Auditors also agreed that sections other than the opinion also hold a degree of importance to users. In contrast, both bank lending officers and financial advisers agreed significantly less with all these statements. This is not entirely surprising considering how these two user groups are on the receiving end of the report, and their perceptions are therefore expected to differ from those of auditors, where the p -value < 0.001. Most interviewees (10/12) remarked that users were likely to only consider an UAR from the aspect of the reliance which it provides to the accompanying financial statements. This is something which can be acquired simply from reviewing the opinion section. Other auditor interviewees (2/6) assumed users' focus will be on the financial statements, rather than the UAR.

User interviewees also argued that there are instances where reference is also made to the 'Basis for Opinion' section. However, statistical findings suggest contradictory results since a discrepancy was identified in the views expressed by users and auditors regarding the importance of this section,

whereby users tend to give it less importance than auditors.

The Communication Aspect

Decision-Making Importance

Stakeholders, particularly lenders, strongly agreed with the importance of the UAR when making lending decisions, resulting in a statistically significant result ($p=0.001$) between lenders and their counterparts. This is inconsistent with Asare and Wright (2012) whose study identified no statistical differences in the views expressed by lenders and auditors concerning the importance of an UAR in decision-making.

Auditor interviewees (4/6) argued that lenders may assign higher importance to the UAR since the auditor's opinion on a set of financial statements plays a key role in assessing whether credit should be granted to the entity in question. Alternatively, financial advisers seemed more sceptical about the confirmation of an unmodified audit opinion in the UAR ($p<0.001$) given their significantly lower mean rating score. Auditor interviewees (2/6) suggested that since advisers typically deal with larger entities whose opinion is seldom qualified, they are likely to gather additional entity-specific information rather than rely on the AR. If the investment that the financial adviser is providing advice on is listed, then even more publicly available information should be accessible, including share prices, company announcements or interim reports.

This result contradicts Duréndez Gómez-Guillamón (2003) who identified the AR to be equally useful to both user groups. This denotes how in comparison to foreign countries, local banks tend to rely more on this report as a source of financial information than Maltese financial advisers, as portrayed by the statistically significant different result between the two user groups for statement 4 in table 3 above.

Despite the statistical significances derived, all groups essentially agree that the UAR is an important decision-making tool. Although lenders tend to place a higher degree of reliance on it in comparison to financial advisers, interviewees (5/12) identified this report to be a mere starting-point since, decisions on whether to invest or provide credit to the entity under review can

ultimately be made from the figures in the financial statements and not simply on the conclusions in the audit report per se.

Communication of the Key Message

User and auditor interviewees shared similar views on how the key message of an UAR is stipulating that: “the FS provide a true and fair view” and “in all material aspects are presented in line with an applicable framework”. However, the statistical results displayed for statement 2 in Table 3 depict users’ disagreement with auditors regarding the clarity with which this message is being communicated in the report, including its understandability.

Although one auditor in a medium sized firm argued that the sophisticated user ought not to find any difficulty in understanding the message in the AR, most auditor interviewees (5/6) agreed with the above result, arguing that at times the message in the AR is unclear. This is understandable since users must consider an audit from a third-party view; hence, it is more difficult to understand the judgement undertaken by the auditor to arrive at the audit opinion issued.

Confidence provided by the Unqualified Audit Report

The study by Asare and Wright (2012) revealed that that when users, specifically bankers, in their study were provided with an unmodified audit opinion, they assumed that it provides a certain confidence on the following factors: [i] entity’s shares being a sound investment; [ii] entity being well-managed; [iii] entity’s ability to reach its strategic goals. Auditors in Asare and Wright (2012) had disagreed with bankers, prompting p-values approximately equal to 0, denoting widespread gaps amongst all three factors.

In comparison, when this study attempted to uncover whether these prevalent differences also exist locally, the statistical results suggest only one discrepancy as shown in statements 6–8 in Table 3. Lenders strongly agreed with the UAR’s ability to instil confidence in the reader that the entity in question is a sound investment due to its unmodified opinion ($p=0.009$), whereas auditors strongly disagreed with this statement. This difference may be explained by the lack of a precise

explanation in the UAR on how an unmodified opinion is not intended to provide confidence on these elements, as Asare and Wright (2012) had suggested. This suggests how further clarification could be included to ensure that there are no misunderstandings regarding the implications of an unmodified opinion.

Communication of Technical Terminology

This section discusses the challenge encountered by users in understanding the technical jargon incorporated in an UAR, including discussions on whether this jargon can be further explained to reduce the degree of interpretation by users.

(i) Understanding the technical jargon

Table 4 demonstrates how sophisticated users’ level of difficulty encountered in understanding the four technical terms presented was much lower than that expressed by auditors. The discrepancies amongst users and auditors for each term presented was significant, as all p-values were approximately 0. This shows that auditors underestimate users’ ability to understand the UAR’s technical jargon, since, the results show that users find the technical terms challenging to understand.

Interviewees exhibited consistent results; all users (6/6) were able to correctly interpret ‘Reasonable Assurance’ and ‘True and Fair View’ with users’ explanations for both terms being consistent with auditors’ definitions. Only one lender was unable to interpret ‘Material Misstatement’ correctly. Although interviewees were able to identify ‘Fairly Present’ as being interchangeable with ‘True and Fair View’, some (3/6) noted how ‘Fairly Present’ was more ambiguous than ‘True and Fair View’. This substantiates McEnroe and Martens’ (1998) findings, where users and auditors had both assumed ‘fairly’ to convey something else beyond fair presentation with GAAP.

The error bar graph in Figure 1 demonstrates how ‘Fairly Present’ is scoring significantly higher amongst participants as being a term which is quite difficult to understand, in comparison with ‘True and Fair View’ since the two respective error bars are disjoint. Therefore, interviewees were asked

whether the easier understood term should replace the use of 'Fairly Present' in UARs. Most interviewees agreed that having two terms in the UAR with the same meaning could be a driver of ambiguity. However, one auditor argued that sophisticated users should have sufficient knowledge and expertise to distinguish between the different interpretations of these two technical terms.

Additionally, certain auditors (3/12) stated that 'True and Fair View' is already used in most audit opinions issued locally, as the tendency is for this term to be used in UK and EU countries, whereas 'Fairly Present' is more commonly used in the U.S. (McEnroe and Martens, 1998). Furthermore, the researcher concludes that much of the uncertainty surrounding 'Fairly Present' is justified by the fact that this term is not extensively used in local audit opinions issued, hence users are not accustomed to it.

[Insert Figure 1 here]

(ii) Explanation of terms

Table 5 shows how participants believe that 'Material Misstatement' is the term which needs to be clarified most in the UAR. Conversely, 'Reasonable Assurance' was identified as the term requiring the least clarification, as demonstrated by its overall low mean rating score; this is not entirely surprising given that the IAASB has recently added the latter's definition in the report. A p-value less than 0.05, for 'Reasonable Assurance' and 'True and Fair View' demonstrates how lenders disagreed with auditors and financial advisers as to how these terms need to become more clarified in the UAR.

[Insert Table 5 here]

However, bank lenders strongly disagreed with both auditors and financial advisers regarding the proper explanations which the following two terms currently hold in the UAR, depicted by their significantly lower mean rating score as demonstrated in Table 6:

[Insert Table 6 here]

Material Misstatement exhibited the lowest p-value ($p=0.003$) of all terms, indicating lenders' strong view that this term is not well-explained in the UAR. Materiality is a highly subjective concept in auditing and unless auditors disclose materiality thresholds in the UAR, which are currently not mandatory locally, one can never be entirely sure

on what the auditor is referring to when mentioning this term.

Reasonable Assurance also attained a p-value which was considerably low; the fact that the UAR provides no quantification for the assurance conveyed (e.g. 80% confidence that the FS are fairly presented), this high assurance allows for numerous interpretations.

The above shows that lenders highly disagreed with auditors' and financial advisers' perceptions regarding the sound explanation currently provided in the UAR for these two terms. The fact that these two terms are highly associated with a lack of quantification suggests how introducing quantification, may assist the reader with an interpretation of the UAR.

The Information Aspect

Sufficiency and value of recently enhanced/introduced areas

In this section we aim to consider the value and sufficiency of certain changes made through the most recent revision to the AR, by comparing users' and auditors' perspectives.

[Insert Table 7 here]

As illustrated by the overall mean rating scores, Table 7 demonstrates participants' considerable agreement with the value of the:

Description of KAMs;

Affirmative statement about auditor independence; and

Engagement partner name disclosure

However, there were disagreements amongst the three groups regarding the amount of information being provided through:

The auditor's responsibilities section; and

The affirmative statement on independence and ethical responsibilities.

Auditors expressed their satisfaction with the amount of information provided on their responsibilities and key features of an audit ($p<0.001$). Users strongly disagreed with auditors in this respect, suggesting how additional information on an audit may be required. Additionally, lenders disagreed with the added value of this recently enhanced section ($p<0.001$), possibly because this merely increased the amount of boilerplate text in the report. However, the auditors' stronger agreement with the value emanating from this

section may be explained by their professional self-interest; the granular detail which the paragraph goes into to describe what is within the scope of the auditor to perform and limitations encountered during an audit, improves protection from instances of litigation.

The affirmative statement on auditor independence scored the second highest of all additions in terms of its value-adding ability ($p=0.010$), whereas the ethical considerations part was considered as the least value-adding ($p<0.001$). Disagreements amongst auditors and users were identified for both independence and ethical statements. Auditors' stronger agreement may be justified by their professional obligation; they are more likely to look positively upon sections which clarify their ethical responsibilities, making it clear-cut to the reader as to what the auditor's obligations involve. Since this section must remain identical from one issued AR to another, users are likely to be more interested in other audited areas not typically mentioned in the AR, particularly areas identified as consisting of significant risk by the auditor during an audit (Vanstraelen et al., 2012).

Another discrepancy was identified between auditors and users regarding the statement of auditors' responsibilities section's ability to provide enough information ($p<0.001$). Users believed that further information should come out of this section; interviewees, expressed their interest in knowing the steps taking by auditors to safeguard their independence and ensuring that all ethical obligations have been adhered to, for the different audits performed. This contradicts Vanstraelen et al. (2012) where auditor interviewees suggested that independence information may not be so important to users, denoting how given our small-island state setting, independence is given a higher consideration by local users.

All participants shared similar views on the value of disclosing the 'Engagement Partner's Name' in an UAR ($p=0.252$); this scored the third highest in value from all additions effected in this reform. This contradicts Vanstraelen et al. (2012) where users had considered disclosing the audit firm in the UAR to be sufficient, and information on the engagement partner name was not required. However, interviewees suggest contradictory results since no interviewee mentioned the value achieved

from this addition. Considering how certain users were not even aware of the reform the UAR experienced, the research suggests that it is possible that certain users may have learnt about this addition throughout the questionnaire dissemination, where those who may have been previously unaware would have found it value-adding. This is even more plausible given the limited number of local stakeholders who actually read an entire UAR.

Statistical results demonstrate how KAMs is the third most important section of an UAR, with the 'Description of KAMs' identified by the auditors as being considered the reform's most valuable addition by all participant groups ($p=0.525$). However, lenders believed that the amount of information this section currently conveys may not be satisfactory ($p=0.010$). In this section, auditors also discuss how they addressed the identified KAMs during the audit, however, lenders did not consider this information to add value to the UAR ($p<0.001$).

Introduction of Key Audit Matters: Perceived Drawbacks

This sub-section elaborates on the newly introduced section of KAMs and delves into drawbacks and benefits potentially emanating from it.

[Insert Table 8 here]

Mean rating scores in table 8 show that participants essentially agreed that the two main potential drawbacks of KAMs may be that:

They can be misunderstood by readers outside the accountancy profession; and

The illustrations provided by the IAASB on KAMs may encourage the use of similarly standardised text in the UAR.

Lenders strongly agreed with how auditors may be inclined to use standardised text when disclosing KAMs. Cordos and Fulop (2015) suggested that if KAMs were to become standard from one AR to another, their added-value stands to diminish. Such standardised text would also prove harder for certain users with a limited accounting background to decipher the information communicated, which is consistent with the IAASB's (2011) views shared on JOAs. Less concerning drawbacks of KAMs (based on the overall mean ratings scores) included how they can

potentially: [i] divert users' attention from other important parts of the FS; and [ii] reduce management's willingness to share information with their auditors. Statistically significant results were identified amongst all stakeholder groups for these statements:

Lenders particularly agreed with the first aforementioned possible drawback of KAMs ($p=0.047$); this is consistent with findings from Sirois, Bedard and Bera's (2018) experiment. This also emerged during interviews, where a lender expressed her concern that readers of the AR may focus their attention on the notes or disclosures pointed out by auditors through KAMs, whilst potentially ignoring the remaining content.

Auditors showed greater concern towards the second aforementioned potential drawback of KAMs ($p=0.022$), supporting Cade and Hodge's (2014) findings where due to an auditor's obligation to disclose KAMs, managers may be less willing to communicate openly with their auditor. Considering that KAMs have been in place for a few years, and the fact that local auditors particularly agreed with this statement, it is possible that they have already encountered circumstances where their relationship with the reporting entity's management could have been affected. However, the low score attained and interviewees not having mentioned this point in the interviews, demonstrates that Maltese auditors do not frequently encounter such situations.

Introduction of Key Audit Matters: Perceived Benefits

According to participants, the benefits of KAMs mainly consist of enhancing the UAR's: [i] transparency; and [ii] communicative value. However, Table 9 shows that lenders strongly disagreed with both perceived benefits, suggesting that they do not consider KAMs to be effective in improving the UAR's communicative value and transparency. Bank Lending Officers' disagreement with the reform's introduction of additional information in the AR also suggests how further improvement in the overall content of the report is required as to provide them with both value-adding and transparent information that can be useful to their decision-making.

Statistical results show that lenders were significantly more inclined to express KAMs' potential adverse effects, rather than their possible benefits; hence, this introduction may not have been looked upon so positively by this group. This supports Boolaky and Quick's (2016) findings, where KAMs were not deemed to have a great impact on German lenders' decisions in the process of granting credit. Additionally, since non-PIEs do not have a mandatory requirement for inclusion of KAMs and the majority of companies in Malta do not fall within this obligation because of their size, it is possible that Maltese lenders who typically cater for these types of companies, see no value in KAMs given they are excluded from most UARs read.

Interviewees argued that the increased information which KAMs provide, ultimately exceeded any potential shortcomings, since additional information in the template of the report, provides more insight on the entity. Consistent results were reported by the ACCA's (2018) study in Malaysia; investors have become more lenient towards reading an AR before reviewing the FS. Nevertheless if KAMs are not read, any potential benefits emanating from them would become negligible.

[Insert Table 9 here]

Closing the Gaps

Interview findings suggest three main avenues for standard-setters to potentially close the Communication and Information gaps in the future (illustrated in Figure 2):

[Insert Figure 2 here]

For terms such as 'Fairly Present', rather than complicating and increasing the AR with additional clarifications, replacement should be made with simpler terms consistent with the Commission on Auditor Responsibilities' (AICPA, 1978) suggestion. Interviewees suggested a glossary as the best way to clarify the jargon contained in the UAR. The glossary would be updated to include any additional terms which come into effect following any ISA changes as applicable to the audit industry. However, there is a risk that the glossary may not be referred to, mainly because the UAR's contents would increase and information may not be clearly visible in an overly extensive report. Instead, the AR could include a hyperlink to

a website which contains the relevant explanations and therefore help reduce the risk of information overload.

To ensure that various readers' interpretations of the UAR are more aligned, for the term 'Reasonable Assurance' standard-setters may consider introducing a more precise metric to gauge the level of assurance an audit provides. In the case of materiality disclosures, since such thresholds are more complex to determine and quantify, Demanuele (2016) suggested that disclosing these may not have the intended effect locally, since the Maltese market is not extensively developed; therefore, any shortcomings would greatly outweigh any benefits in small nation states. Additionally, considering the confusion which two interchangeable terms such as 'Fairly Present' and 'True and Fair View' can cause, (9/12) interviewees suggested that standard-setters should potentially consider introducing one phrase which is appropriately defined to help achieve consistency.

There is a challenge on what the ideal content and length of an AR should be. On the one hand, interviewees suggest that the AR should be non-standardised to allow auditors to provide more explanation and information, but be in a pre-set format. On the other hand, certain clarifications or tailor-made reports may not always be viable, hence a shorter and concise UAR can be essential to enhancing communication, since excessive information can pose more confusion for the readers when trying to decipher what information is relevant for them. Moreover, sophisticated users often have limited time to read reports, so the lengthier the AR, the less time they will devote to reading it (Church, Davis and McCracken, 2008). Therefore, conciseness can be crucial in encouraging more users to read the report, which ultimately proves to be the fundamental issue.

Implications for Closing the Gaps: Communication

Although widespread CGs have not been identified locally as in foreign studies, there are improvements which can help to mitigate this gap. This study identifies three main barriers which may prevent such improvements from being implemented, illustrated in Figure 3:

[Insert Figure 3 here]

We have already herein established how standardisation is a major issue in the UAR; this text appears to have an insignificant effect on users' perceptions, since it typically contains technical jargon, making it harder for the non-accountant to decipher. The level of AR reading currently undertaken by users in this study is concerning¹ suggesting that, particularly for the less sophisticated individual, the less reading one engages in, the less they are expected to understand the auditor's view on a set of FS.

(3/6) auditor interviewees suggested that the gap lies within users' expectation of an audit. The fact that an AEG exists and will probably persist in the future, obstructs individuals with a limited accounting background from understanding the auditor's communications. The IASB (2010) suggests that even those enjoying a sound level of financial knowledge may encounter difficulty in understanding certain accounting notions. This is even more concerning given that 1 Big Four auditor suggested that in a small-island state, sophisticated users may lack the necessary expertise when compared to peers in larger and well-developed countries.

In evaluating a set of FS and accompanying AR, most users will be making a forward-looking assessment of the financial position and strategy of the company; this is something which is outside of the scope of an audit. Additionally, the purpose of reading through the AR by users differs, which leads to taking different approaches when analysing a set of FS, depending on the reader's background as also argued by Scott (1994). Conversely, the auditor would have simply attained comfort with the numbers of the FS and expressed an opinion in the AR. Another limitation for users is that the AR will not list all the judgements exercised by the auditor during the audit. This element of subjectivity leaves room for conceivable perceptual differences as well as unjustified reliance and expectations by users.

Implications for Closing the Gaps: Information

The IAASB (2011) recognised how an increasingly informative AR is crucial for today's

¹ Refer to Chi-Square test result in Figure 4.

business environment. Indeed, findings² demonstrate that respondents agreed as to how the UAR should provide additional information; interviewees suggested that further entity-specific information could be included whilst having less stringent restrictions imposed on the template of the AR. Additionally, interviewees also requested that higher emphasis should be placed on communicating information on higher risk areas where the auditor is required to exercise judgement. This further highlights the need for improvement in the information currently provided, pinpointing the existence of an IG locally (refer to Figure 4).

[Insert Figure 4 here]

Stakeholders recognised that the information included in the AR is a fraction of the information available to the entity's management and its auditors (IAASB, 2011). Although presenting certain information safeguards the viability of capital markets (Bookey and Quick, 2016), there are restrictions on the information which both management and auditors can disclose. Certain information cannot be disclosed as it may undermine a company's competitive position. Auditors on their part, face restrictions on information disclosure due to client confidentiality.

Findings suggest that users are unaware of the work performed by auditors throughout an audit; they seek additional tailor-made information about how each audit is conducted, such as the sampling criteria or testing performed. Although tailor-made ARs may contain more of the information users would like to obtain, the downside is that readers need to put additional effort to understand this new information. Additionally, the auditor's workload would increase, leading to a substantial increase in client audit fees; this would have an adverse effect on the smaller companies in small-island states, where the statutory audit may already be burdensome.

The IAASB (2011) acknowledges how certain information may need to be sourced from the entity's management as they are the party responsible for producing the FS. However, because auditors are independent from the entity, the IAASB recognises that if the auditor could provide

his/her impartial insight on particular matters, the AR's relevance would increase. Nevertheless, one financial adviser argued that it may be unfair for stakeholders to demand certain information from the auditor, since the AR is not being issued specifically for any particular stakeholder. Although users utilise the report, hence the term, this is ultimately drawn-up for the entity's shareholders.

Conclusion

In this study we focused on the impact of the revised UAR on three stakeholder groups, namely auditors and two sophisticated financial statement users (financial advisers and bank lending officers).

We concluded that the most important element in an UAR is the audit opinion, with local bank lenders being the user group which places a higher degree of reliance on this section of the report. Given that most of the text in the report is standardised, the level of attention given to other sections depends on the auditee being considered in a user's investment or lending decision, including its perceived risk profile. The reputation of the audit firm which conducted the audit engagement is also a key consideration for users, allowing them to gauge the level of trust they can place in the audited financial statements.

Results also suggest that in reaching a lending decision, lenders prefer to read an UAR in a more detailed manner than financial advisers typically would. However, there appears to be a lack of clarity with which users believe that message of the UAR is being communicated, with several lender interviewees suggesting that this message is rather ambiguous. Auditors believe that this ambiguity arises from the judgements which they exercise throughout an audit to reach their audit opinion. This represents information that the users cannot have access to. Additionally, there are users who are not fully aware of the scope of an auditor's role, which is a key factor for the communications gap.

We analysed whether UAR readers understand the meaning and implications of certain technical terms, namely 'Reasonable Assurance', 'Material Misstatement', 'Fairly Present' and 'True and Fair View'. Findings suggest that since users are not given explicit quantification of the level of confidence being conveyed by the term 'Reasonable

² Refer to table 7, statements 1 and 2

Assurance' and the materiality thresholds applied in determining 'Material Misstatement', they were unable to assess the assurance level being portrayed and materiality levels exercised. 'True and Fair View' was identified by users as being simpler to understand than its counterpart 'Fairly Present', presumably emanating from its prevalent use in the local context. Whenever possible, it is suggested that simpler terms be substituted for imprecise technical jargon; and clarification should be provided in the UAR when replacements of technical terms are not feasible.

From the enhancements to the UAR stemming from the revision of ISA 700, the 'Description of KAMs' section was considered to have mostly added to the UAR's transparency and communicative value. This notwithstanding, all three participant groups were concerned that the additional level of technical knowledge required to understand the auditor's message in this section could limit the users' understanding of the information being discussed. This may be particularly relevant in Malta, a small-island state, since auditors suggest that even sophisticated users may not always be conversant with technical accounting jargon.

Given the importance of this area in the newly revised AR and the overall element of ambiguity associated with the overall message and contents of the AR, there may be the need for the Maltese auditing profession to re-evaluate the audit firms' use of KAMs. Although the larger audit firms may be subject to quality checks and internal reviews, curbing potential deviations from guidelines and standards, smaller firms may prefer to follow closely any standardised templates, given their limited time, resources and technical backing. By ensuring that the correct wording is used, the communication of KAMs can be enhanced, mitigating any ambiguity which may arise in the UAR.

This also calls for the need to hold information sessions with user groups, to highlight the importance of this section and the remainder of the UAR. Information sessions may be provided on how KAMs can be correctly utilised as part of the users' assessment of an entity's FS in evaluating its financial standing both from an investment or a lending perspective. This ensures that KAMs and

the UAR in its entirety reach their intended purpose of enhancing users' decision-making ability.

Ultimately, as auditors must adhere to their confidentiality obligations, requirements to divulge KAMs to financial statement users should not impinge on their relationship with the client. It is suggested that the two parties should engage in a discussion on the matters auditors intend to include as KAMs before KAMs are actually disclosed. This is imperative, since transparency may be impaired if management becomes less willing to disclose significant entity information with the auditor.

Despite the IAASB's attempt to steer away from standardisation through KAMs, findings indicate that Maltese AR users still have an appetite for additional information to be included in the AR. Disclosing this information could encourage readers to analyse and understand this section in greater detail. However, the potential downside for small entities is an increase in audit fees as a result of the additional work auditors would be required to perform to tailor the report for each entity audited. In a small-island state scenario, a concise AR may be more useful to encourage users to read the whole report, prevent misinterpretations and retain audit fees at a minimum level. Widening its scope may not be as feasible given the prevailing high proportion of small companies, most of which are owned-managed ones or family-owned businesses.

Our study has certain limitations, namely that it only incorporated selected groups of sophisticated users. Furthermore, a mix of sophisticated and non-sophisticated users could be incorporated in a similar study which could shed light on differences existing between Maltese users holding varied levels of sophistication. Additionally, given that the results show that quantification of certain terms may help enhance users' understanding of the assurance level contained in the report, a future study could consider the potential implications this type of disclosure would have in an UAR.

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