

**THE FINANCIAL STATEMENTS EXPECTATIONS GAP IN
A SMALL STATE ECONOMY – A MALTESE PERSPECTIVE**

by

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ABSTRACT

Over the years, there has been a lot of discussion about the *audit* expectations gap. Research on the expectations gap has focused exclusively on the audit aspect, with limited attention being given to the possibility of the existence of other elements that may in fact contribute to an even wider expectations gap. This study has focused on the *financial statements* expectations gap. Financial statements are the public face of an organisation. It is therefore crucial that users understand their objective, message, scope and limitations. This study explores and evaluates the existence of a financial statements expectations gap in a small state economy, namely Malta. The data for this study was collected from shareholders and auditors in Malta using a mixed methods approach with a sequential explanatory design through the use of a survey questionnaire and semi-structured interviews.

The findings have shown that the financial statements expectations gap exists in various areas, some of which are fundamental to the understanding of financial statements. There is a clear lack of clarity, or confusion, about the objective of financial statements. This appears to be the result of the over-emphasis on decision-usefulness as an objective of financial statements, the imprecision of the word “stewardship” and the failure to communicate clearly the scope and limitations of financial statements. The study has shown that the attempts by standard setters to satisfy various user needs with the same set of financial statements were unsuccessful in Malta. Communicating financial information has been identified as the primary purpose of financial statements. However, the understandability of financial statements was negatively impacted primarily by the complexity of information, the frequent changes to standards, information overload and the use of technical jargon. The study has accordingly identified those factors that are considered to be conducive to the understandability of financial statements in Malta.

Based on the research findings, the study has provided recommendations to the accountancy profession and policy makers on how to address the financial statements expectations gap. Potential areas for future research were also identified.

Keywords: financial reporting; financial statements; expectations gap; financial statements expectations gap; financial reporting expectations gap; objective of financial statements; message of financial statements; communication; small state; Malta

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LIST OF ABBREVIATIONS

AAA	American Accounting Association
ACCA	Association of Chartered Certified Accountants
ACL	Alternative Companies List
AGM	Annual General Meeting
AICPA	American Institute of Certified Public Accountants
APA	Accountancy Profession Act
ASB	Accounting Standards Board
ASCPA	Australian Society of Certified Practising Accountants
BCCI	Bank of Credit and Commerce International
CICA	Canadian Institute of Chartered Accountants
CPE	Continued Professional Education
EU	European Union
FCR	Financial Reporting Council
GAAP	Generally Accepted Accounting Principles
GAPSE	General Accounting Principles for Smaller Entities
GAPSME	General Accounting Principles for Small and Medium-Sized Entities
GDP	Gross Domestic Product
IAASB	International Auditing and Assurance Standards Board
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation

IBM SPSS	IBM Statistical Package for the Social Sciences
ICAA	Institute of Chartered Accountants in Australia
ICAEW	Institute of Chartered Accountants in England and Wales
ICAS	Institute of Chartered Accountants of Scotland
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
ISA	International Standard on Auditing
MIA	Malta Institute of Accountants
MSE	Malta Stock Exchange
SME	Small and Medium Sized Enterprise
UK	United Kingdom
US	United States

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CHAPTER ONE - INTRODUCTION

1.1 OVERVIEW OF THE STUDY

There has been a lot of deliberation and discussion on the audit expectations gap over the years (for example, Fadzly and Ahmad, 2004; Dixon *et al*, 2006; Hassink *et al*, 2009; Porter, 1993; Ruhnke and Schmidt, 2014). This debate was the driving force for a number of developments effecting the profession, including the expansion of the audit report in the early 1990s and the debate about the responsibilities of the auditor. A number of approaches have been proposed over the years with a view to bridging this gap. Examples include enhancing the education and training of users, distinguishing clearly between the auditors' and directors' responsibilities (particularly with respect to the prevention and detection of fraud, errors and other irregularities), explaining the inherent limitations of the audit process and issuing more comprehensive auditing standards to guide the work of practitioners. (Monroe and Woodliff, 1993; Porter, 1991; Ruhnke and Schmidt, 2014).

Empirical research on the expectations gap has focused, almost exclusively, on the "audit expectations gap". A lot of emphasis has been placed on the "audit" aspect of the financial reporting process. Accordingly, research studies have focused on a wide spectrum of issues relating to the audit expectations gap, most notably the factors contributing to its existence and possible solutions aimed at narrowing this gap. There has been a lot of debate and controversies over the years on the audit expectations gap, leading to extensive research on the subject and a lot of discussion (for example, AICPA, 1978; ICAEW, 1986; CICA, 1988; Guy and Sullivan, 1988; Hatherly *et al*, 1991; Porter, 1991; Humphrey *et al*, 1992; Porter, 1993; Gramling *et al*, 2000). However, in sharp contrast to this, much less deliberations have been made on the "*financial statements* expectations gap".

It is important to first of all set out the distinction between "corporate reporting", "financial reporting" and "financial statements" since these terms are sometimes erroneously used interchangeably.

There is no one universally agreed-upon definition of corporate reporting. Financial statements are often associated with corporate reporting. However, financial statements are only one element of the corporate reporting chain. This is because investors obtain key information from many other sources, such as directors' reports, earnings releases and analysts' presentations (KPMG, 2013). Corporate reporting is the "link between a company and its investors" (Deloitte, 2016, p. 2). Corporate reporting has at its foundations the need to keep current and potential investors informed about the company, and about the actions of those to whom they have entrusted the responsibility of managing the entity (Deloitte, 2016). Corporate reporting therefore includes the entire collection of statements and reports that comprise the financial report. Examples of statements (other than the financial statements) include the following: narrative reporting, corporate governance remuneration, corporate responsibility and integrated reporting.

At the core of corporate reporting is financial reporting, which consists of financial statements and accompanying notes that comply with generally accepted accounting principles (FEE, 2015). Financial statements are the structured representation as prescribed by accounting standards of the financial performance and financial position of an entity. According to IAS 1 Presentation of Financial Statements (para. 10), a complete set of financial statements comprises the following components: a statement of financial position as at the end of the reporting period, a statement of profit or loss and other comprehensive income for the period, a statement of changes in equity for the period, a statement of cash flows for the period, notes comprising a summary of significant accounting policies and other explanatory information, and comparative information prescribed by the standard (IASB, 2016a). IAS 1 allows an entity to use titles for the statements other than those stated above, but it is a requirement for all statements to be presented with equal prominence. Moreover, IAS 1 (para. 14) states that any reports that are presented outside of the financial statements (such as financial reviews by management, environmental reports, and value added statements) fall outside the scope of IFRSs (IASB, 2016a).

It is also important to distinguish between general purpose financial statements and special purpose financial statements. General purpose financial statements are defined

by the IAASB as “financial statements prepared in accordance with a general purpose framework”, with this latter term being defined as “a financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.” (IAASB, 2014, p.21). On the other hand, special purpose financial statements are defined as “Financial statements prepared in accordance with a special purpose framework”, with this latter term defined as “A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.” (IAASB, 2014, p.35). Special purpose financial statements have been scoped out of this research study. Thus, any reference to “financial statements” throughout this study has to be interpreted and understood as a reference to “general purpose financial statements” prepared under the relevant applicable accounting framework.

This study focuses on *financial statements*. Financial statements are the public face of an organisation. It is therefore crucial that users understand their scope and limitations. This thesis explores and evaluates the existence of a financial statements expectations gap in a small state economy, namely Malta. It gives the main interested stakeholders, namely the auditors and the shareholders, a chance to express their views on a much neglected topic: *the message being conveyed through financial statements*. Disagreements between respondents can indeed provide evidence of an even wider expectations gap than has so far been researched in Malta.

1.2 BACKGROUND INFORMATION

A substantial amount of literature discusses the audit expectations gap between the perceptions of auditors and the perceptions of users of financial statements (see, for example AICPA, 1978; ICAEW, 1986; CICA, 1988; Guy and Sullivan, 1988; Hatherly *et al*, 1991; Porter, 1991; Humphrey *et al*, 1992; Porter, 1993; Gramling *et al*, 2000). Such literature focused on the expectations gap from the perspective of the auditors issuing an opinion on the truth and fairness of financial statements, and that of the users of an audited set of financial statements.

The research undertaken over the years on the audit expectations gap indicates that it exists for various reasons. For example, Humphrey *et al* (1993) and Porter and Gowthorpe (2004) argued that the audit expectation gap existed because of deficiencies in an auditor's performance and auditing standards. Other researchers (Pierce and Kilcommins, 1996; McEnroe and Matens, 2001) argued that the gap existed due to misinterpretations and misunderstandings of the meaning of auditing by stakeholders. These studies suggested that there is a misunderstanding by users on the audit function and that such misunderstanding led to unrealistic expectations. Earlier on, research by Porter (1993) identified the following components of the expectations gap: deficient performance, deficient standards and unrealistic expectations. These components did not, however, remain unchanged over time, and in fact, a study by Porter and Gowthorpe (2004) showed that such components had changed, albeit that the perceptions of pessimism on the audit function had not been eliminated.

The audit expectations gap has been acknowledged as a worldwide problem and an international issue for many years. For example, in the United States, new auditing standards were introduced in 1988 as a response to the audit expectations gap problem. The audit expectations gap was also identified in the UK and other developed and developing countries. Over the years, a number of initiatives have been undertaken by the auditing profession in order to improve audit quality by enhancing the extent of the auditors' compliance with professional standards and other relevant regulations. These steps were expected to improve confidence in auditing and were therefore expected to narrow the audit expectations gap. Such initiatives included, for example, the introduction of audit quality review programmes and the publication of improved international auditing and assurance standards that were meant to be understandable, clear and capable of consistent application. The over-arching objective of these initiatives was to enhance the quality and uniformity of audit practices across the globe.

Despite these initiatives, major concerns have been raised over the years about the company audit function as a result of a number of high profile corporate scandals, such as Polly Peck International and BCCI in the UK, Enron and Worldcom in the US, Parmalat in Italy and Olympus Corporation in Japan. These concerns have increased

exponentially during the recent financial and economic crisis that started in 2008. Financial scandals in an increasingly regulated world have been greeted with a cry for more government regulation (Myddelton, 2004). Regular calls have been made for investigations on the grounds that auditors were being very complacent about their role. Questions were raised on the rigourness with which audits were being performed. The auditor's level of professional skepticism was being seriously questioned. As a result, the role and effectiveness of the audit function were the subject of a significant number of high level inquiries in the UK, Brussels and the US. The European Commission's wide-ranging Green Paper on audit, the inquiry on audit competition conducted by the House of Lords Economic Affairs Committee in the UK, and the changes to the reporting model examined by the US Public Company Accounting Oversight Board are all examples of the challenging questions raised and the scrutiny with which the audit function was being subjected to. In 2010, the UK's Financial Reporting Council issued "The Audit Firm Governance Code" with the objective of providing recommendations for auditors to be seen as exemplars of best practice governance. Corporate governance principles were now being extended and applied to audit firms themselves, with core principles relating to leadership, management, values, and operations being given due consideration (ICAEW, 2010).

The financial crisis itself, together with the extent of inquiries and questions raised, may have reduced confidence in auditing (Dobroţeanu *et al*, 2009). The audit function was under fire (ACCA, 2011), and indeed, at times of crisis, when investor confidence is fragile, the role of the auditor is challenged even further. The growing literature on the audit expectations gap may be seen as an indicator that this is a significant problem that merits yet additional research. The myriad research studies and inquiries have culminated in several rich literature reviews and research findings that, in sum, afford policy makers and practitioners alike an appreciation of the existence of an audit expectations gap.

Although the expectations gap has a long and persistent history (Koh and Hoo, 1998), recent developments (for example, the financial economic crisis of 2008 and the IASB's recent focus on better communication in financial reporting) clearly indicate that the expectations gap is still a relevant issue to investigate, but from a "financial statements"

point of view. It is increasingly being considered that the role of the financial statements is not simply confined to giving a true and fair view of an entity's state of affairs. It seems that much more is being expected in relation to the financial health of the entities (Scicluna, 2010). Such an expectation brings into question a wide array of issues - matters such as the sustainability of business models, the analysis of business risk and forward looking business plans and financial outlooks. Such matters fall clearly outside the realm of the financial statements preparation presently governed by accounting frameworks and their subsequent audit under the applicable auditing framework.

Notwithstanding such literature on the audit expectations gap, it is clear that there is still a knowledge gap on this subject. Higson (2003) argued that it is useless to only tackle the audit expectations gap. This is because he feared that there is a bigger expectations gap relating to the financial statements themselves. Higson (2003) therefore contended that there are two separate and distinct elements making up the “financial reporting expectations gap”, and these are illustrated in Figure 1.1.

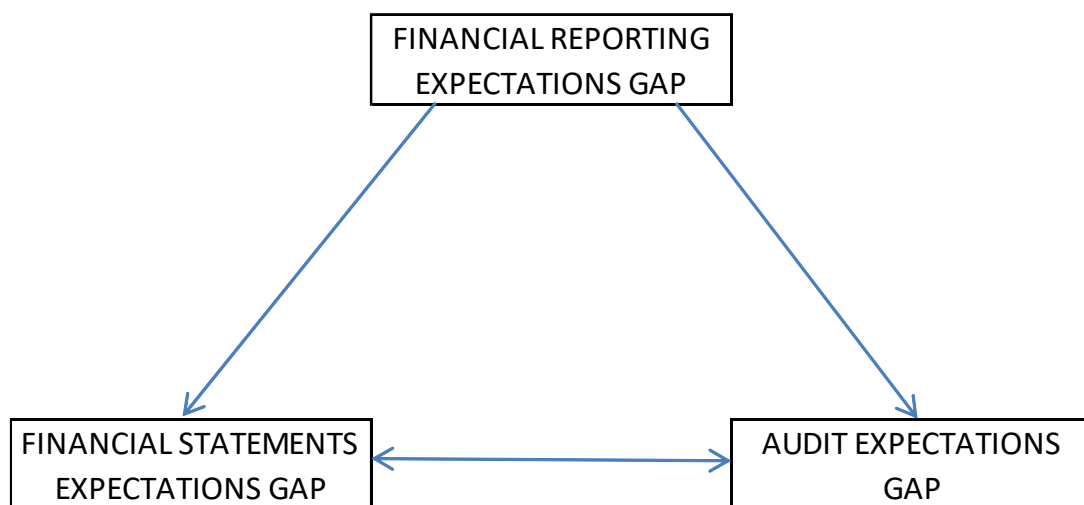


Figure 1.1 The financial reporting expectations gap (Higson, 2003, p.13)

Figure 1.1 draws a distinction between the “financial statements expectations gap” and the “audit expectations gap”, which together comprise the “financial reporting expectations gap”. Higson (2003) suggested that the possible components of the financial statements expectations gap included the emphasis on decision-usefulness, the prediction of future cash flows, the imprecision of the word “stewardship”, and connotations that

the balance sheet represents wealth. Higson (2003) also argued that the limitations of financial reporting are not communicated well enough to enable their proper understanding, thereby contributing further to the financial statements expectations gap. In addition, another contributing factor was the pre-occupation and importance afforded by standard-setters to satisfying various user needs with the same set of financial statements.

Accordingly, this study addresses this knowledge gap and it provides a contribution to research by addressing the research objectives that are set out in Section 1.3. Although it is acknowledged that corporate reporting has changed and developed significantly since 2003 when the key framework for the study was developed (Higson, 2003), the researcher still considers the expectations gap to be a contemporary phenomenon worth investigating, specifically with reference to the financial statements.

The importance of the subject being investigated in this thesis was re-confirmed in 2016 by the Chairman of the International Accounting Standards Board (IASB) who advised that the Board would henceforth be focusing on “making financial statements better tools in the communication between companies and their investors” (IASB, 2016b, p.6). Indeed, the IASB acknowledged that preparers of financial statements experienced financial reporting as being too much of a compliance exercise and therefore investors believed that the financial statements depicted performance in an insufficiently clear manner. The result was that “valuable information gets drowned out by the ‘tick the box’ disclosures and voluminous, but poorly organized and presented financial data” (IASB, 2016b, p.3). In 2017, the IASB therefore launched its “Better Communication in Financial Reporting” project aimed at improving the effectiveness of financial statements, a theme that was described as an “overarching theme” and “a source of inspiration for the coming years” (IASB, 2016b, p.3).

1.3 OBJECTIVES OF THE RESEARCH STUDY

As will be demonstrated in Chapter Two, research on the expectations gap has mainly focused on the audit aspect, with limited attention being devoted to the possible existence of other elements that may contribute to an even wider expectations gap.

Within the Maltese context, research at undergraduate level within the Department of Accountancy at the University of Malta has also focused exclusively on researching the existence of an audit expectations gap and considering possible ways of bridging this gap. Thus, this study attempts to fill the research gap in this area within the Maltese context by focusing on the viewpoints of the two primary parties involved in the financial reporting process: (i) the shareholder, and (ii) the auditor.

Auditors are considered to be an appropriate group of participants for the purpose of this study for a number of reasons. Auditors are experienced and knowledgeable in the field of accounting standards and financial statements. They are expected to be the more experienced group in relation to the scope and limitations of financial statements. They also play a particular role within the research setting (Malta). In practice, Maltese auditors are often involved in assisting clients in dealing with the more technical aspects of financial reporting, and they therefore have an important say in the preparation of financial statements in Malta. It is therefore considered that a comparison of the views of the two groups of participants is necessary to provide a comprehensive view on the subject matter within the research setting, Malta.

The main research objectives of this study are the following:

1. to investigate the views of auditors and shareholders in Malta on the objective of financial statements; and
2. to identify the respondents' perceptions on the message being conveyed through audited general purpose financial statements; and

3. to analyse the possible existence of a financial statements expectations gap in a small state, namely Malta.

The study will therefore be designed to provide answers to the following research questions in order to achieve the aforementioned research objectives:

Research Question 1 (RQ1): *To what extent does a wider expectations gap (i.e. wider than the “audit expectations gap”) exist in Malta in relation to financial statements?*

Research Question 2 (RQ2): *Are external auditors and shareholders in agreement about the objective and the main use of financial statements in Malta?*

Research Question 3 (RQ3): *Are financial statements being interpreted as being capable of predicting an entity’s future cash flows?*

Research Question 4 (RQ4): *To what extent do respondents consider financial statements as being reflective of the performance (past and future) of the reporting entity?*

Research Question 5 (RQ5): *Are the limitations of financial statements communicated well-enough?*

Research Question 6 (RQ6): *Do certain characteristics (e.g. behavioural aspects) of a European small island state such as Malta intrinsically influence the perceptions on the message being conveyed by financial statements?*

RQ1 and RQ2 are the two key research questions of the study. They are the overarching research questions that focus on the research gap being investigated. RQ3 to RQ6 are further research questions that inform the answers to the two key research questions of the study.

1.4 RESEARCH METHODOLOGY

Most of the research studies that have been undertaken to date have focused on the audit expectations gap. They have generally used a model or theory followed by testing a hypothesis concerning the existence or otherwise of the audit expectations gap. Researchers used the statistical results to accept or reject the hypothesis, and then derived conclusions based on the research findings. Different respondent groups have been used to elicit different opinions – these include shareholders, auditors, lawyers and judges, jurors, finance directors, investment analysts, bankers and the general public. Most studies have investigated the nature of the expectations gap and sought to identify the critical components of this gap with a view to devising solutions towards bridging the gap. Other researchers have interviewed relevant respondent groups and subsequently performed an analysis of the responses received.

The objectives of this thesis have been achieved by selecting pragmatism as the research philosophy for conducting research in this area and using a mixed methods approach with a sequential explanatory design. Pragmatism provides justification for mixing research methods with the ultimate objective of addressing the research questions. The research objectives of this study have therefore been addressed using a combination of different research activities as follows:

- (a) Literature review – the literature review comprised the theoretical underpinning, conceptual frameworks and empirical findings relating to the expectations gap. Such research material was obtained from books, academic journals and web-based information (for example, web-sites of international bodies such as IFAC). Most of the existing literature relates to the audit expectations gap and therefore this thesis addresses a knowledge gap in the academic literature in this respect. Given the contemporary nature of the issues being investigated and developments occurring over time, the literature review process has been a continuous one throughout this research study. The objective was to reflect all relevant research on the subject matter. In addition, consideration was given to ensuring that the thesis remained up to date with the latest academic knowledge and that therefore, any regulatory updates and/or research papers relevant to the subject would be duly incorporated in the study.

- (b) Research fieldwork - Chapter Four presents the philosophical approaches that were considered for this research. The assumptions relevant to the nature of reality, the basis of knowledge and the nature of the research methods are considered in this chapter.

Data collection for this thesis was conducted in two phases: a quantitative phase and a subsequent qualitative phase. The research fieldwork was therefore based on a combination of both quantitative and qualitative research methods.

A pilot study was initially used to test the research instruments. This was followed by in-depth interviews to ensure that the questions are understandable, and to ascertain that the research objectives of the study could be attained from the responses given to the questions set. Any suggestions for improvements were given due consideration and included in the resulting final questionnaire and interview schedule.

A structured questionnaire was first distributed to the participants (Maltese auditors and shareholders) by means of a survey to enable the researcher to investigate the views of respondents using quantitative techniques.

However, questionnaires generally suffer from low response rates and may not be the best instrument for asking detailed probing questions. Accordingly, data collection was then supplemented with personal semi-structured interviews with a sample of participants from both groups. These interviews were conducted subsequent to the collection and analysis of responses from the questionnaires. In this way, the research findings emanating from the first research phase were referred to during the second stage of the research fieldwork process.

This study aims to investigate, analyse and discuss the existence of a financial statements expectations gap in Malta. It seeks to find out what is happening in the real world in order to seek new insights, ask questions and/or assess phenomena in a new light. It therefore encourages the discovery of views and responses from the participants' perspective based on their understanding and interpretations. It was

considered that such views and responses could best be elicited by combining insights from qualitative and quantitative research.

The use of a mixed methods approach therefore helped to provide a more comprehensive understanding of the nature of the financial statements expectations gap in Malta, its multidimensionality and its impact on local audit practices.

(c) Analysis and interpretation of findings - the process of data analysis necessitated a two-fold approach:

- (i) empirical answers to the questionnaires were statistically analysed using IBM SPSS Statistics software (Version 24);
- (ii) responses to the personal interviews were transcribed in those cases where permission to record the interview was granted by the interviewee. In those cases where the interviewees expressed their preference not to be recorded, the salient points from the interview were faithfully reproduced and summarised by the interviewer. An analysis of the interviews was then performed using Nvivo (Version 11) in order to identify similarities and differences in themes between the two interviewee groups.

The over-arching objective of this research project was to investigate and analyse the possibility of a financial statements expectations gap in a small country such as Malta. As already explained, previous research mainly focused on the audit expectations gap, with limited or no attention being given to the existence of other factors that may contribute to an even wider gap, particularly with a small island context.

Phillips and Pugh (2005) identify four elements or analytical constructs that are to be considered in a PhD study, namely background theory, focal theory, data theory and contribution (see Figure 1.2). These elements do not necessarily have to correspond exactly with chapter headings, but they are present throughout the research study.

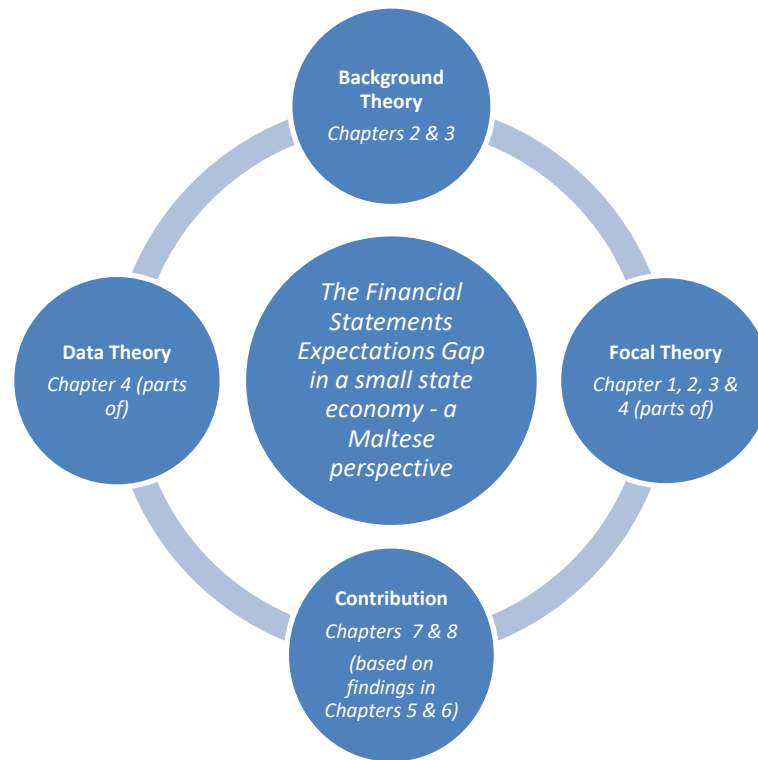


Figure 1.2 Background theory, Focal theory, Data theory and Contribution

Background theory identifies the framework within which the research has been conducted and defines the current state of knowledge in the subject area of the thesis. The existing body of knowledge relevant to the research matter being investigated is included in Chapters Two and Three, with a research gap relating to the financial statements expectations gap being duly identified.

Focal theory focuses on the nature of the problem and how the researcher set about analysing it. It involves the researcher spelling out in detail precisely what is being researched, thereby establishing the nature of the problem and how the researcher proposes to set about analysing it. The generation of hypotheses (if appropriate), the examination of other researchers' arguments and the use of the research findings and analysis to push forward the academic discussion are the key tasks to be performed. Focal theory is addressed in a number of chapters in the thesis: Chapter One provides an introduction to the research setting to identify the nature of the problem area; Chapters Two and Three examine relevant arguments in the literature, while Chapter 4 articulates the research methodology and design of the study.

Data theory provides the justification for the relevance and validity of the material that is used to support the thesis (Francis, 1976 cited in Phillips and Pugh, 2005). This includes an epistemological discussion about which interpretative framework is appropriate. Accordingly, the data theory is outlined through the description of the research methodology in Chapter Four.

Naturally, the research findings (included in Chapters 6 and 7) are a central component of a thesis, but they are not the only central component. Phillips and Pugh (2005) use the term “contribution” to cover the research findings and also an explicit evaluation by the researcher of the significance of the findings. Contribution therefore includes a discussion on the significance, limitations and implications of the findings with the objective of providing an addition to the existing body of academic knowledge in the subject area. In general terms, contribution is a discussion as to “why” and “in what way” the background theory and the focal theory referred to at the beginning of the thesis are now different as a result of the researcher’s work. This important aspect of the thesis is duly addressed in the final two chapters.

1.5 SETTING THE SCENE OF THE RESEARCH ENVIRONMENT – MALTA

The Republic of Malta is an island state in the Mediterranean Sea, located circa 93 kilometres to the south of Sicily and 288 kilometres to the east of Tunisia. Malta is a member of the European Union and it also joined the Eurozone on 1 January 2008. It has a population of circa 400,000 people and the Maltese archipelago is composed of two main islands: Malta, having an area of circa 246 square kilometers, and Gozo, with an area of circa 67 square kilometers. Malta is the smallest of the European Union’s member states, yet it is one of the fastest growing financial services centres. The financial services industry enjoys strong support from both Maltese mainstream political parties, with the government’s stated intention of turning financial services into one of the mainstays of the economy. The quality of its regulatory regime and the level of service offered as an industry have been repeatedly lauded by international clients who have set up in Malta.

The accountancy and audit profession in Malta is regulated by the Accountancy Profession Act (APA). The Accountancy Board is appointed by the Minister responsible for finance in Malta. The composition of the Accountancy Board is as follows: it is made up of a chairman and six other members, all of whom are to be non-practitioners and knowledgeable in the areas relevant to statutory audit and accounting. All aspects of the profession in Malta are regulated by the Accountancy Board. These aspects include, but are not limited to, advising the Maltese Government on the approval of accounting and auditing standards, ethics and the issue of guidelines from time to time to practitioners. The Code of Ethics drawn up by the Accountancy Board is based on the code recommended by the International Federation of Accountants (IFAC).

In terms of the APA, accountants can qualify to obtain a warrant to function as such only on satisfying the following conditions: (i) they have followed an accountancy degree course at the University of Malta; or (ii) they possess an academic qualification relating to the accountancy profession that is recognised as appropriate by the Accountancy Board. In addition to obtaining the aforesaid academic qualification, adequate practical accounting experience is also required in order to be awarded a warrant to practice as an accountant in Malta. A separate practicing certificate in auditing is required to be able to practice in the audit profession in Malta.

Companies in Malta are required by the Companies Act (Chapter 386 of the Laws of Malta) to keep proper accounting records sufficient to give a true and fair view of the company's results and affairs. The Companies Act also imposes other statutory obligations on companies, such as filing an annual return and submitting a copy of the company's financial statements with the Registrar of Companies. The accounting requirements are broadly similar to those in the UK and are also in line with the EU Directives.

Up to 2015, the Companies Act and the Accountancy Profession Act made International Financial Reporting Standards as adopted by the European Union ("IFRSs as adopted by the EU") the default accounting framework to be adopted by companies in Malta. Financial statements were accordingly to be prepared on the basis of this accounting

framework. Certain qualifying companies could, however, have elected to adopt the Accountancy Profession (General Accounting Principles for Smaller Entities) Regulations, 2009 (GAPSE) as their accounting framework. This was an election that was available to certain companies. In order to be able to qualify for this election, due regard had to be given to both quantitative and qualitative criteria. GAPSE was a simpler accounting framework when compared to IFRSs as adopted by the EU. In particular, it contained a number of measurement simplifications. For example, all assets were, under GAPSE, measured at cost less, if applicable, impairment. Goodwill and intangible assets with indefinite useful lives were amortised over a maximum period of twenty years. Disclosure was another area that GAPSE sought to simplify in order to try and reduce the extent of disclosures included in financial statements. GAPSE therefore contained a number of disclosure relaxations when compared to IFRSs as adopted by the EU. For example, the following disclosures were not required: the impact of future standards, critical accounting estimates and judgments, financial risk and capital management, ultimate controlling party and transactions with key management personnel.

The EU Single Accounting Directive 2013/34/EU (the “Directive”) resulted in a new set of financial reporting requirements for companies in Malta. The over-arching objective of the Directive was to simplify the preparation of statutory financial statements for qualifying micro, small and medium sized entities. The accounting aspects of this Directive were transposed into Maltese law through Legal Notice 289 of 2015, which introduced the General Accounting Principles for Small and Medium-Sized Entities (GAPSME). The issue of this legal notice consequently resulted in the demise of GAPSE and the introduction of GAPSME. GAPSME superseded GAPSE for financial reporting periods commencing on or after 1 January 2016. The default accounting framework in Malta changed as a result of the publication of GAPSME. IFRS as adopted by the EU was no longer the default accounting framework. GAPSME became the new default accounting framework for small and medium sized enterprises in Malta.

The applicability of GAPSME as an accounting framework was also increased. This is because GAPSME widened the thresholds of applicability when compared to those previously applicable under GAPSE. Although GAPSME has now become the default

accounting framework, Maltese SMEs may still decide to prepare their financial statements in accordance with IFRSs as adopted by the EU. This decision requires a resolution of the board of directors of the company, confirming that the company is electing to use IFRS as adopted by the EU for the purpose of preparing its financial statements. It is important to note that large and public interest entities (such as listed entities) fall outside the scope of GAPSME. Such companies must still prepare a full set of financial statements in accordance with IFRS as adopted by the EU, and GAPSME is therefore not available to them as an option.

The auditors of a company in Malta are required by the Companies Act to make a report to the shareholders on the annual accounts examined by them. This report, referred to as the auditor's report, must be drawn up in accordance with the Companies Act and International Standards on Auditing (ISA). Amongst other things, the auditor's report has to state whether, in the auditor's opinion, the financial statements prepared by the directors have been properly prepared in accordance with the applicable financial reporting framework, and whether they give a true and fair view of the financial position, financial performance and cash flows of the company. In addition to reporting on the truth and fairness of financial statements, the auditors of a company also have responsibilities under the Companies Act to report by exception to the company's shareholders on certain other matters prescribed by the Act (for example, whether returns adequate for the audit were received from branches not visited by the auditor and whether certain disclosures of directors' remuneration specified by law are made in the financial statements).

The applicable auditing standards in Malta are the International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB), and accordingly, statutory audit engagements are to be undertaken in accordance with the requirements of these standards. In practice, the auditor may come across situations where certain matters come to the auditor's attention that prevent an unqualified opinion from being issued. In such cases, the auditor must set out clearly the reasons why he is unable to give an unqualified opinion as required by the relevant applicable auditing standards. Modifications to the auditor's report is also a matter that is regulated by

auditing standards, with appropriate guidance being given to the auditor on how to deal with such circumstances.

1.6 NEED FOR THE STUDY

This thesis is the first study that attempts to research and evaluate the existence of a financial statements expectations gap in Malta. It therefore contributes to the existing literature in two main ways.

Firstly, it extends the existing knowledge on the expectations gap in Malta by providing evidence of the existence of a wider expectations gap than has previously been researched. This study takes the existing literature on the expectations gap a step forward by exploring the existence of a wider gap and providing empirical findings to support this, and for the first time, by testing its implications on a small state economy such as Malta. Auditing and financial reporting have an important role in society and unless the existence of a wider gap is researched and understood, there is the risk that the legitimacy of the audit and accountancy profession in society may be impaired.

Secondly, this study contributes to financial reporting and auditing literature in a small country, having the inherent characteristics that are normally attributable to small economies. The Maltese financial reporting environment differs from that in other countries such as the UK in many ways. Aspects such as the smallness factor, the strength of behavioural relationships, the confidentiality paradox and attitudes to change and enforcement are only some of the key characteristics of a European small island state that inevitably influence accountancy and audit practices. This study could provide a framework for studying the financial statements expectations gap in Malta and be useful to academics, policy makers and other researchers. Furthermore, being a small state, the Maltese scenario may be used to research a model that could eventually be adopted on a larger scale.

The findings of this research study could also have implications for audit practices. Indeed, the success or otherwise of performing statutory audits cannot be measured solely

from the perspective of the auditors, but also from the point of view of the primary users of financial statements, namely shareholders. It is therefore critical that any legitimate expectations of shareholders be given due consideration.

Finally, the significance of this study also emanates from the fact that it focuses on a much neglected topic in financial reporting. Financial statements are the public face of an organisation, yet their message is often misunderstood – it is therefore crucial that users clearly understand the scope and limitations of financial statements.

The relevance of the study is reinforced by the fact that in 2017, the IASB decided that “Better Communication” would become a central theme of its work in the coming years. According to the IASB, this shall require a fresh look at how information in financial statements is presented, how it is grouped together and in what form it is made available. The fact that “financial statements” and the “communication” of relevant information finally feature high on the IASB’s agenda is a further proof of the relevance and need of this study. Indeed, this thesis was substantially concluded in 2017 at the time when the IASB embarked on a major project focusing on better communication in financial reporting.

1.7 THE CONTRIBUTION OF THE STUDY

Providing answers to the research questions set out in Section 1.3 informs the objectives of this study, thereby resulting in a contribution to the relevant literature. In broad terms, this research makes a contribution to knowledge by adding a single country study to the literature on the expectations gap, but in the context of financial statements instead of the audit function. The Malta case is of relevance in particular to small states, but also to developed economies and other countries that may share cultural, political and economic features with Malta.

In more specific terms, this study focuses its attention away from the audit function and into the financial statements themselves. This study is therefore different and distinct from previous literature on the audit expectations gap. It provides a contribution to

literature by providing empirical evidence of the existence of a wider expectations gap than has been researched so far. It therefore takes the existing literature on the expectations gap one step forward by exploring the existence of a wider gap and providing empirical findings to support this. It also contributes to knowledge in the field of accountancy by focusing on a much neglected topic in financial reporting – the financial statements. Whilst auditing has an importance function in corporate governance and in society at large, it is the financial statements that ultimately convey information on the reporting entity to the readers.

This study also contributes to knowledge in the generally under-researched field of communication in accounting by focusing on the message being conveyed through financial statements. It shows that despite having an important communicative function, the message of financial statements is often misunderstood. It provides empirical evidence in support of this identifying those factors that are curbing the understandability of financial statements. It also shows that there is a lack of consensus, even within the two respondent groups themselves, on the objective of financial statements, which is expected to be at the very foundation of the financial reporting process. Given that the objective of financial statements is unclear, the resulting message being communicated is likewise obfuscated.

Finally, this study has, for the first time, tested empirically the existence of a financial statements expectations gap. To the best of the author's knowledge, this is the first single country academic study which focuses on the financial statements expectations gap and which provides empirical evidence in support of its existence. Furthermore, the study has been carried out in a small state economy (Malta) and it therefore adds further knowledge to small states literature.

1.8 OUTLINE OF THE THESIS

This thesis consists of a total of eight chapters. The first chapter discussed the background and rationale for the study, outlined the study's motives and specified the research questions.

The overall structure of this thesis is illustrated in Figure 1.3.

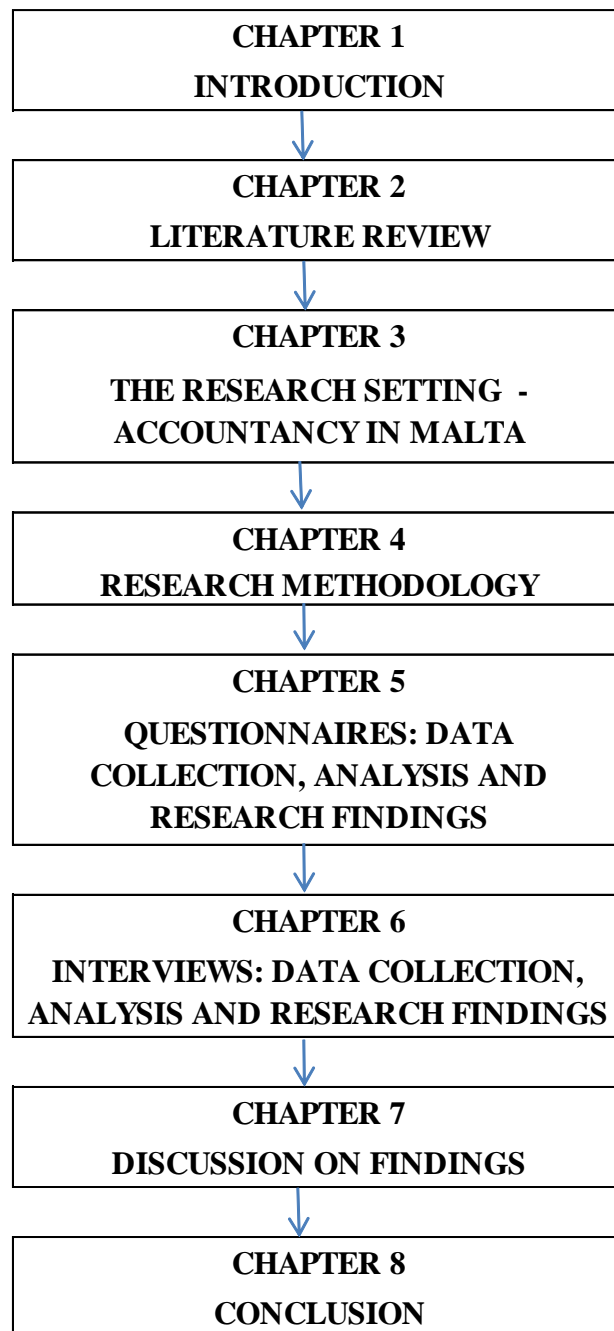


Figure 1.3 – The overall structure of the thesis

A review of the literature on the expectations gap is covered in Chapter Two. It explains the evolution of the expectations gap over the years and also identifies the causes and

prominent issues on an international level. It also provides the background of the regulatory guidelines and standards governing the preparation of financial statements.

Chapter Three discusses the accounting and auditing frameworks of the research setting – Malta. It justifies why the study was conducted in Malta and it also highlights the local experiences and research studies conducted to date. It also delves on certain key aspects that emerge as a major influence on accountancy in Malta based on recent research.

Chapter Four presents the formulation of the research hypothesis and outlines the research methodology. A justification for selecting a mixed-methods approach is given in this chapter. It then discusses the research methods used in this study, namely questionnaires and semi-structured interviews. The philosophical approaches that were considered for this research are presented in this Chapter. It explains the close alignment that exists between the quantitative and qualitative research methods adopted in the study and the research questions outlined in the first chapter.

Chapter Five presents the methodological techniques used in the quantitative phase of the study. It provides an explanation of the questionnaire's design, layout and content used as a basis for capturing data from the survey instrument. It describes the sample selection techniques that have been used and it delves into the process of data collection and data analysis. It also presents the findings from this phase of the study.

Chapter Six presents the data collection and analysis techniques used in the subsequent qualitative phase. It presents the interview findings and reports the findings on the auditors' and shareholders' perceptions on the subject matter of the study. Direct quotations from the participants are included to support the presentation of findings, where relevant.

This study separates the description of the findings from their interpretation. Accordingly, Chapter Seven integrates together the findings from the previous two chapters and discusses the resulting implications by relating to the literature on the expectations gap. Contributions made by the study are presented and discussed.

Chapter Eight provides a conclusion and summary of the research findings in relation to the research questions. Finally, recommendations and avenues for future research are also included.

1.9 SUMMARY

This chapter has provided an overview of the research project. Initially, a brief introduction and background information on the key perspectives and concepts of the subject were provided. This chapter has also provided some insight on the accounting and audit frameworks applicable in Malta. The rationale and scope of the research project were described along with the aims and objectives that led to the research questions. This chapter has also set out the research backdrop and it concludes by providing an outline of the structure of the thesis.

CHAPTER TWO – LITERATURE REVIEW

2.1 INTRODUCTION

This chapter provides a comprehensive evaluation of the relevant literature on the expectations gap. Section 2.2 provides an introductory overview to the audit expectations gap. Section 2.3 provides a thorough review of the current state of knowledge on the subject area of the thesis by referring to prior literature and other readily available research studies, concluding with the identification of the research gap. Sections 2.4 and 2.5 focus on possible components of the financial statements expectations gap: the objective of financial statements and the message being communicated by financial statements, while Section 2.6 deals with the understandability of financial statements. Section 2.7 subsequently provides justification for the researcher's use of communication theory as the theoretical underpinning of the thesis.

2.2 THE EXPECTATIONS GAP - DEFINING THE TERM

The relationship between the shareholders and directors of a limited liability company may be considered to be an agency relationship, defined by Jensen and Meckling (1976, p.5) as a relationship in which there is:

“a contract under which one or more persons [the principal(s)] engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent”.

Agency theory postulates that a company consists of a nexus of contracts between the shareholders (the principals) and the directors (the agents). On the assumption that both parties to the relationship are utility maximisers, then there is good reason to believe that the agents may not always act in the best interests of the principals (Jensen and Meckling, 1976; Wallace, 1980). Thus, an agency problem arises. Agents are motivated to serve their own self-interests which may conflict with the principals' interests (Koh and Woo, 2001).

In order to sustain an equilibrium, both parties to the agency relationship tacitly undertake to bear costs: directors restrain their demands at a level below the point at which shareholders would replace them, and thus suffer a bonding cost, whilst the shareholders, as principals in the agency relationship, suffer monitoring costs in order to control the agents (Kent and Sherer, 1983).

The agency argument posits that in a situation where there is a separation of ownership and control, principals are willing to incur a financial cost to monitor the activities of their agents. The agents are responsible for producing most of the information required by the principals. As a result of it being prepared by the agents themselves, this information is, however, seen to be of doubtful objectivity. This is because the information is prepared by the agents themselves, with the presence of a natural or deliberate bias caused by the existence of a conflict of interest (Kent and Sherer, 1983). It is therefore in the principals' interest to engage an independent auditor in order to have the truth and fairness of the financial statements duly testified.

Audits serve a fundamental purpose in promoting confidence in financial reporting. Relationships between principals and their agents are of particular importance in understanding how audits have evolved over the years, and also in analysing how these continue to develop. The statutory audit has developed over at least a century in response to agency risks. The owners of a company delegate responsibility for managing the affairs of a company to the directors. Financial statements prepared by the directors therefore became a primary mechanism that shareholders use in order to hold the directors to account. The statutory audit is therefore a mechanism that helps to ensure that the directors are acting in the best interests of the shareholders.

The existence of an accountability relationship must not, however, be limited only to the shareholders of a company. The principals having an ownership stake in the company are not the only parties that are effected by decisions of the directors. The way in which a company is managed also affects other third parties, such as creditors, bankers and tax authorities, who have no direct ownership interest in the company. Nonetheless, such

external third parties are still considered to contribute to the viability of the entity and are accordingly an important link in the operative life of a company.

Indeed, shareholders are not the only group of people to whom the company, as managed by the directors, should be accountable (Kent and Sherer, 1983). This is not prescribed by the strict provisions of the law; however, realism dictates that a company is also accountable to other stakeholders that are involved with the activities of a company. Thus, the concept of accountability, and the use of the statutory audit to enforce it, is applicable to all sets of participants associated with a company, and not just to the shareholders. The statutory audit per se may not directly address all the conflicting objectives and expectations of the various stakeholders. Notwithstanding this, the audit function is still perceived as a means of ensuring that the financial statements produced are reasonable (Jones, 1997). It also places constraints, in the interests of stakeholders, upon the actions of management, in the knowledge that their financial transactions will be subject to scrutiny by an independent third party (Tabone and Baldacchino, 2003).

Other theoretical frameworks, such as stewardship theory, institutional theory and stakeholder theory, have become prominent in recent times. However, among the various theories discussed, agency theory remains the most popular and has received the most attention from academics and practitioners. The influence of agency theory has been instrumental in the development of corporate governance principles (Laiho, 2011). It has been of considerable importance in understanding the role of the auditor – principals hire external auditors who, as agents under contract, are expected to be independent of the agents who manage the company. The role of the external auditor is therefore to reduce agency costs by cutting information asymmetry in financial reporting (Piot, 2001). Agency theory therefore recognises the external audit as important monitoring mechanism (ICAEW, 2005). Watts and Zimmerman (1983) confirm that high quality external auditing undermines the opportunistic behavior cost (agency cost) introduced by management. It is within this context that the importance of fulfilling audit expectations becomes relevant for a proper understanding of the role of the audited general purpose financial statements in modern society (ICAEW, 2005).

There is at present no universally accepted definition of the audit expectations gap. As will be illustrated in this section, several accounting researchers and professional accountancy bodies have come up with their own definitions. The term “expectations gap” was first used in literature by Liggio in the early 1970s; however, the issues relating to the expectations gap, appeared to exist since the late nineteenth century (Humphrey *et al*, 1992).

Liggio (1974, p.27) defined the expectations gap as the difference between “the levels of expected performance as envisioned by the independent accountant and by the user of financial statements”. The Cohen Commission’s terms of reference extended this definition further. The Commission was charged to consider whether a gap may exist between what the public expects or needs, and what auditors can and should reasonably expect to accomplish. The Commission confirmed the existence of an expectations gap, defining it as the “difference between what the public expects or needs and what auditors can and should reasonably be expected to accomplish” (AICPA, 1978, p.xi). The Canadian Institute of Chartered Accountants (CICA, 1988) concluded that the gap consisted of three components: (i) an unreasonable expectations by users; (ii) inadequate legislation, auditing and accounting standards, and (iii) inadequate performance of auditors.

Porter (1993), a significant contributor to literature on the expectations gap, argued that the definitions used by Liggio (1974) and the Cohen Commission Report were too narrow. This is because their definitions failed to consider the possibility of substandard performance by auditors. Porter (1993, p.50) stated that:

“these definitions are too narrow in that they do not recognize that auditors may not accomplish ‘expected performance’ (Liggio) or what they ‘can and reasonably should’. They do not allow for sub-standard performance. It is therefore, proposed that the gap, more appropriately entitled ‘the audit expectation-performance gap’, be defined as the gap between the public’s expectations of auditors and auditors’ perceived performance”.

Porter’s (1993) structure of the audit expectation-performance gap, arguably a refinement of the components reported by CICA (1988), has two major components, namely:

1. Reasonableness gap: the difference between what the public expects auditors to achieve and what they can reasonably be expected to accomplish; and
2. Performance gap: the difference between what the public can reasonably expect auditors to accomplish and what auditors are perceived to achieve. The performance gap may be further subdivided into:
 - a. Deficient standards: the gap between what can reasonably be expected of auditors and auditors' existing duties as defined by law and professional promulgation;
 - b. Deficient performance: the gap between the expected standard of performance of auditors' existing duties and auditors' perceived performance, as expected and perceived by the public.

Hatherly *et al* (1992) adopted another framework based on three levels. The first level represented what the role and responsibilities of the auditor ideally should be; level two focused on the audit responsibilities as currently determined by standards and regulation; level three represented the manner in which the responsibilities are carried out. The difference between level one and level two is termed a “service vacuum”, representing a shortfall between the expectations of auditors and users, and the current auditing standards. Both unreasonable expectations and deficient standards as identified by Porter (1993) contribute to this service vacuum. A performance gap arises at the third level when the auditors fail to perform their work with due professional care and skills, and this corresponds to the deficient performance component of the gap.

Other researchers have also attempted to define this term. For example, Jennings *et al* (1993, p.489) defined the audit expectations gap as “the difference between what the public expects from the auditing profession and what the auditing profession can actually provide”. Humphrey (1997, p.9) defined it as a “representation of the feeling that auditors are performing in a manner at variance with the beliefs of those for whose benefit the audit is carried out”. Humphrey (1997) extended this definition to include other issues such as the adequacy of auditing standards and the quality of audit delivery. McEnroe and Martens (2001) refer to the audit expectations gap as signifying the difference

between what financial statement users recognise as being part of the auditors' responsibilities and what auditors consider their responsibilities involve. According to Eden *et al* (2003), the public expects auditors to uncover errors and evaluate management performance, while auditors believe that the objective of the audit function is to evaluate the fairness of financial reporting. Guy and Sullivan (1988, p.36) stated that:

“there is a difference between what the public and financial statement users believe accountants and auditors are responsible for and what the accountants and auditors themselves believe they are responsible for. This difference is commonly called the expectations gap”.

Sikka *et al* (1998) defined the expectations gap as representing the difference between what the public expects an audit should entail and what the auditing profession decides an audit should entail. Ojo (2006, p.1) considered the audit expectations gap as being “the difference what users of financial statements and the general public perceive an audit to be and what the audit profession claims is expected of them in conducting an audit”. According to the IAASB (2011, p.7), the expectation gap reflects the “difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is.”

The above review of the different definitions attributed to the expectations gap shows that despite the differences in the definitions adopted by different researchers, there are two definite common themes: firstly, the fact that the expectations gap exists, and secondly that it is intrinsically related to the audit function. Both the “spirit” and the “letter” of definitions attributed by academic literature to the expectations gap have focused almost exclusively on the audit aspect. Indeed, the expectations gap is not a new phenomenon – it is not limited geographically and empirical research to date shows that it is related exclusively to the audit function.

2.3 PRIOR LITERATURE ON THE “AUDIT EXPECTATIONS GAP”

A wide range of research has been conducted by a host of researchers in different countries (particularly the UK, US, Australia and other industrially advanced economies) on the audit expectations gap. The literature on this subject is therefore extensive,

triggering prolonged and controversial debates on various facets and implications of the subject over time. Research studies have mainly sought to answer the following questions: What is the nature of the gap? Where is the gap situated? What is the impact of the gap? How can the gap be reduced? Definitions and components of the audit expectations gap have been reviewed in Section 2.2. This section focuses on research undertaken relating to the factors contributing to the existence of the audit expectations gap and recommendations for attempting to narrow this gap.

2.3.1 FACTORS CONTRIBUTING TO THE AUDIT EXPECTATIONS GAP

Various reasons have been researched to explain the cause/s of the audit expectations gap. Traditionally, this has been attributed to a misperception of the audit function by users or the public, leading to a situation where there are over-expectations of the audit function. Some commentators have attributed the expectations gap to the users' confusion, widespread misunderstanding, ignorance and/or lack of education (Sikka *et al*, 1998). According to Church *et al* (2008), there is evidence of misunderstandings regarding the audit process, including misunderstandings on the content and meaning of the audit report, the auditor's responsibilities, the extent of work performed in an audit and the level of assurance provided by an audit engagement. Over the years, this element of "over-expectations" of the auditing function has been promoted by the auditing profession in a number of ways. Auditors have repeatedly argued that the function of a statutory audit is to ensure the conformity of financial statements with an identified financial reporting framework. Auditing standards repeatedly refer to terms such as "reasonable assurance" and "truth and fairness" or "present fairly in all material respects". For example, ISA 200 (para. 5) *Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing* states that auditing standards require the auditor to "obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error". This same standard (ISA 200, para. 5) explains that "reasonable assurance is a high level of assurance" but that "reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit".

Tricker (1982) argued that the audit expectations gap existed as a result of a time lag in the auditing profession reacting to a continuously changing business environment and public expectations. Lin and Chen (2004, p.97) concurred with this view and they argued that the audit expectations gap “emerged as the profession failed to react”.

Auditors have long been asked to detect errors and fraud (Brief, 1975). Literature on the audit expectations gap (e.g. CICA, 1988; Porter, 1991) indicates that users of financial statements perceived the auditor’s role to be twofold – that of detecting errors and fraud, and giving an early warning of company failure. Guy and Sullivan (1988, p.37) stated that:

“Public expectations of corporate auditors with respect to fraud and error are typically stated in terms of a perception that they have a duty to verify that the audited financial statements are free of such matters”.

This user perception is clearly manifested by the typical all-too familiar question of “Where was the auditor?” which is raised whenever there are corporate failures or situations where companies need to materially restate past financial results. These calls also extend to expectations for auditors to give early warnings of companies in financial distress or potential company failures. For example, Mednick (1986, p.72) states that:

“There seems to be a growing public expectation that the auditor will give an ‘early warning’ that a client is making poor financial or product decisions or may be nearing the brink of financial collapse”.

Similar calls on auditors have also been done by regulatory authorities. For example, in addressing a regional council meeting of the Institute of Chartered Accountants in India in 2011, the Governor of the Reserve Bank of India terms auditors as the “eyes and ears of the Central Bank”, commenting that the authorities “trust them to alert us to early warning signals to assist us in the supervisory process” (The Economic Times, 2011). Recent high profile business failures have fuelled this expectation and have clearly provided evidence that auditors seem to be far from meeting this expectation. Perhaps the most widely known case is the collapse of Enron, where the auditors, Arthur Andersen, did not give any warnings that Enron might have going concern issues. Similar considerations relating to failed advance warnings by the auditor also arose in the

bankruptcy of Worldcom, another major bankruptcy filed in the US. Indeed, Low (2002, p.9) comments that “auditing firms have failed to warn in advance of financial problems at nearly half of the companies that sought bankruptcy-court protection during the past eighteen months”. Despite this comment having been made more than fifteen years ago, it is clear that the issue is still predominant today.

The calls on the profession to be held responsible for the prevention and detection of fraud have however been strongly resisted by the auditing profession. Thus, for example, Carmichael (1988, p.41) states that:

“the auditor believes that it is impossible to design an audit to detect all illegal acts, but that auditors should be sensitive in their audit decisions and action to the possibility of material fraud and error existing”.

Materiality, as well as the inherent limitations of an audit process, are usually the reasons presented by the profession against being held responsible for searching for fraud notwithstanding its size. Thus, for example, McInnes (1994) argues that it is unreasonable to have an expectation that the auditor will issue a guarantee or certification that there is no material fraud in the financial statements. McInnes (1994) opined that if auditors did check every transaction, they could still not provide a guarantee that there have been no material fraud as the auditor might still be deceived by collusion and the forging of documents. In consonance with this argument, ISA 240 *The auditor’s responsibilities relating to fraud in an audit of financial statements* states that:

“An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.” (para. 5)

The profession’s repeated attempts to avoid fraud detection duties were motivated to protect its self-interest in order to deflect public pressure and reduce auditor’s legal liability (O’Sullivan, 1993; Tidewell and Abrams, 1996). This is particularly relevant in an increasingly litigious business environment where auditors are usually in the first line

of attack by investors and/or users seeking remedies in court. Despite the absence of a specific legal requirement holding auditors responsible for the detection and reporting of fraud, they are nevertheless expected, by the majority of the financial and business community and the general public, to detect all or at least all material, corporate fraud (Porter, 1997). Numerous empirical studies have also been conducted on the perception of responsibilities and research findings point in the same direction. For example, a study by Humphrey *et al* (1993) amongst auditors, financial directors bankers, financial journalists and investment analysts, found significantly different views between the participants – 57% of auditors disagreed that the auditor should ensure all significant fraud is detected, while 86% of users thought otherwise. Epstein and Geiger (1994) conducted a similar study on investors' perceptions on the responsibilities of auditors, concluding that more than 70% of investors believed auditors should be held responsible for absolute assurance and also for detecting misstatement due to fraud. In Malaysia, Fadzly and Ahmad (2004) explored the relationship between auditors and the financial community which included brokers, bankers and investors – in this case, all the users expected the auditors to detect fraud.

The different expectations on the auditor's responsibilities can also be analysed in terms of the different public groups having varying levels of audit knowledge and different interests. Ruhnke and Schmidt (2014) identified two broad groups of non-auditors (public groups): internal and external groups. Internal groups consisted of the auditee's management and those charged with governance, while the external groups included external users of audited financial statements such as investors and providers of finance. Whilst external groups were less likely to be aware of auditing standards than internal groups, they had a higher expectation on auditors' responsibilities as their knowledge was obtained from the media rather than from auditing standards.

This responsibility debate has, however, affected the profession in a positive way – it served to make the profession aware that it had a duty to continuously assess auditing standards in light of the expectations, concerns and criticisms of others and develop new standards to bring the auditors' responsibility and performance closer to public expectation (Porter, 1996). The profession's response, albeit still remaining reluctant to

extend responsibility for fraud detection, focused on increasingly putting more efforts to revise auditing standards from time to time to accommodate changing public expectations. Auditing standards have become more concrete and provide detailed guidance on how to identify, investigate and report frauds, errors and other irregularities. The ISA Clarity Project is one such example. This project led to more consistency in the application of ISAs, with the objective of promoting a global acceptance of ISAs (especially in jurisdictions where ISAs are not followed) and also improving the quality of audit. However, Hooks (1992) claimed that efforts by the profession over time to update standards were mainly motivated by the profession's self-interest in protecting the status of self-regulation and alleviating public criticisms without substantially changing the profession's position.

Ruhnke and Schmidt (2014) distinguish between three types of failure to which the audit expectation can be attributed, as illustrated below:

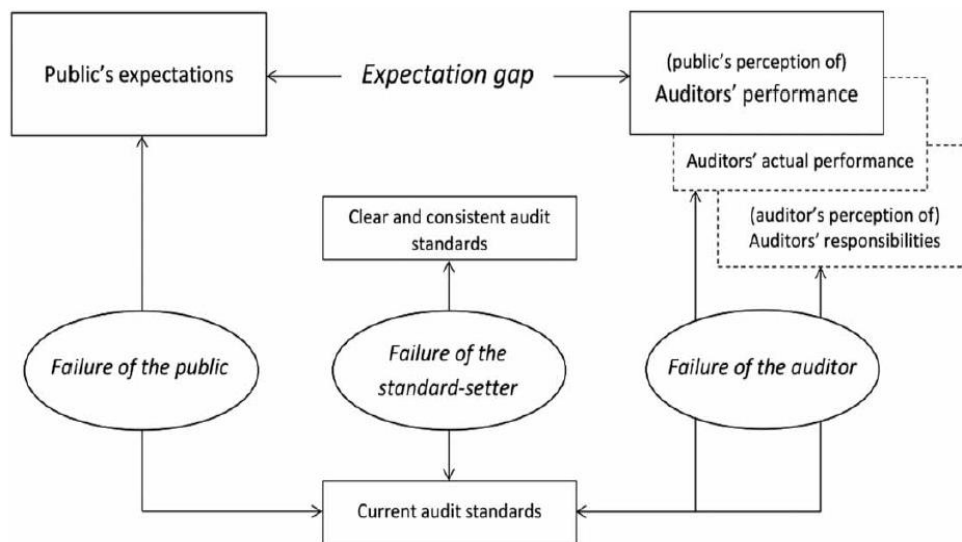


Figure 2.1 – The audit expectation gap under the current regime – definitions and causes (Ruhnke and Schmidt (2014, p.574))

Ruhnke and Schmidt (2014) focused on three types of “failures”: (i) the failure of the public was caused by the failure of the public to obtain sufficient information about the requirements of auditing standards and thereby developing an uninformed expectation on the auditor's responsibilities; (ii) the failure of the auditor arose when auditors failed to apply auditing standards correctly and was also a result of the divergence between the

auditors' own view of their responsibilities and the current auditing standards; and (iii) the failure of the standard-setters existed within the current regime if auditing standards were inconsistent or failed to communicate auditors' responsibilities unambiguously and clearly.

Over the years, various strategies or attempts were made to try and narrow, if not eliminate, the audit expectations gap. It is only with the proper identification of the causes of the failures of such strategies that a proper understanding of the expectations gap can be developed.

2.3.2 ATTEMPTS TO NARROW THE AUDIT EXPECTATIONS GAP

There have been over the years many different approaches proposed and examined by researchers with a view to narrowing the expectations gap. Again, researchers have focused exclusively on the "audit" aspect, with the objective being that of narrowing the audit expectations gap by exploring ways of how the disparity can be resolved (for example, Guy and Sullivan, 1988; Hatherly et al, 1991; Porter, 1991; Humphrey et al, 1992; Porter, 1993; Gramling et al, 2000; Fadzly et al, 2004; Dixon et al, 2006). The focus of these approaches, some of which have been duly implemented by the profession over the years, have been therefore directed at the audit function.

The attempts at narrowing the audit expectations gap have emerged from different countries. The first ones emanated from the US where the Cohen Commission's (1978) recommendations included inter alia clarifying the responsibility for the detection of fraud, enhancing the role of the independent auditor in society and improving auditor's communication with users. Similarly, the Treadway Commission suggested other ways of narrowing the gap, which can be summarised as follows (AICPA, 1987): improving audit quality, improving detection capabilities, improving communication, improving the audit standard setting process and improving the training of business and accounting students. The AICPA Audit Standards Board responded to these concerns by issuing standards, sometimes referred to as the "expectations gap standards". Guy and Sullivan (1988) grouped these standards as follows: (i) detection of fraud and illegal acts; (ii) more

effective audits; (iii) improved external communications; (iv) improved internal communications. In particular, one standard relating to audit reporting introduced the long form audit report meant to provide users with a clear understanding of management's responsibilities and those of the auditor. To a certain extent, the audit report became a means of educating financial statement users by including explanatory paragraphs about the respective responsibilities of the auditor and those charged with governance.

Despite the use of the long form audit report, considerable misunderstandings remained prevalent. This is reflected, for example, in the report of the Audit Quality Form's (AQF) Working Group on Auditor Reporting (2007, p.8) in which it recorded its "concern over the differing perceptions among stakeholders... shareholders, boards [of directors], auditors, regulators and other stakeholders... of the purpose of an audit". Despite the use of the long form audit report, empirical evidence still called into question the sufficiency of the audit report. For example, in a focus-group study involving financial statement users and external auditors, Gray *et al* (2011) concluded that the intended communications of the unqualified audit report were not particularly clear, and that users had difficulty understanding key concepts (such as materiality, sampling and assurance) in the audit report. Furthermore, many participants indicated that their concern with the audit report was simply to determine whether it contained a qualified or unqualified audit opinion, without actually reading the text of the audit report. Empirical research also suggested that the use of the long form audit report to reduce the audit expectations gap was unsuccessful. This finding was consistent across a number of countries and through the use of various research methods. For example, Coram *et al* (2011) evaluated the new audit report using a verbal protocol study with sixteen financial analysts who performed a company valuation based in part on a set of audited financial statements. Their findings indicated that users only briefly analysed the audit report. Their only focus with respect to the audit report was whether the audit report was qualified or not. Baskerville *et al* (2010) performed an experiment using four different versions of the audit report (two short forms and two long forms). The conclusion of this experiment was that the different versions of the audit reports did not have significant influence on the messages perceived by users. Gold *et al* (2012) conducted a similar study in Germany, again concluding that

the explanations in the revised audit reporting standard did not reduce the audit expectations gap.

Attempts at reducing the audit expectations gap were also made in the UK. One example was the expansion of the audit report in the early 1990s. The ICAEW promoted educating the public about the purposes and limitations of the audit processes. It also encouraged the profession to adopt a more positive approach in addressing the expectations gap (ICAEW, 1986). The Research Committee of the Chartered Accountants of Scotland (ICAS) also introduced several proposals to meet public expectations. These proposals were concerned with the responsibilities of boards of directors and responsibilities of external auditors, including their independence, accountability and legal liability (ICAS, 1993).

A number of studies have also been conducted on narrowing the expectations gap through education (e.g. Beck, 1973; Monroe and Woodliff, 1993; Gramling *et al*, 1996). The role of education in reducing the expectations gap was given importance by various commentators. For example, Mednick (1986) proposed that it was better to educate the public as to the role and limitations of an audit. Most of the empirical studies on the impact of education on the audit expectations gap used survey questionnaires to students. Monroe and Woodliff (1993) surveyed auditing and marketing students at the beginning and at the end of a semester. The findings of their survey showed significant changes over the semester in the auditing students' beliefs about auditors' responsibilities and the reliability of financial information. In contrast, marketing students' responses changed on just a few scales across the identified factors. Moreover, the changes noted were not in a consistent direction. Similarly, Gramling *et al* (1996) examined the students' perceptions on the responsibilities of auditors. Data was obtained before and after the completion of an auditing course. The perceptions of professional auditors were also obtained. The study found that an expectations gap existed between practising auditors and accounting students. It concluded that education could help reduce the audit expectations gap since it improved the users' understanding of the audit process. Pierce and Kilcommins (1996) also found that education led to a significant reduction in misunderstandings on audit regulation by those students who had studied either a full

course in auditing or a single module in auditing. Furthermore, the data suggested that these improvements were not merely short term in nature, but were relatively permanent. Powell (1964 in Briloff 1967a, p.59) also recommended the “educate them to understand” strategy for the accountancy profession to repair the communication bridges with the private investors.

Darnill (1991) suggested that the complexities of modern commercial life and the role played by auditors in the business world should be taught at universities. Turner (2006) also recommended colleges to require internships and bring more practical experience into the classroom as one of the principles to help the state licensing board meet the expectations of the public. The empirical results of a survey conducted by Ali *et al* (2008) also showed a significant change in perceptions among students after an internship program covering audit processes, the roles of auditors and audit activities. However, students in this survey still held auditors responsible for some duties which were not statutory requirements.

The proponents of increased education on auditing consider this as a possible solution to resolving user misconceptions regarding the role and responsibilities of the auditor, as well as in helping users to understand the message being conveyed by financial statements. Boyd *et al* (2001) opined that the indisputable way to narrow the gap was to better educate the public on the limitations of an audit. Educating the public was clearly the objective when in the 1950s, over 70,000 copies of a pamphlet were distributed in the UK to banks and other groups having an interest in financial reporting. These pamphlets included information describing an audit, audit reports and auditor responsibilities (Boyd *et al*, 2001). These early efforts were the profession’s attempts to bring public perception in line with the profession’s notion of its role. They represented the profession’s attempt to bring public perception on the audit function closer to reality. According to Boyd *et al* (2001), it was important for the users to “understand what today’s financial statements say, what they don’t say, what auditors do and what they don’t do”. Boyd *et al* (2001) argued that increased educational efforts should be used to communicate an audit’s merits and limitations, and that this should happen with clients and audit committees, at

shareholder meetings, in professional and civic organizations, and at every available juncture.

These views and empirical results are, however, in sharp contrast to views expressed by some other researchers who have criticised the role of education in narrowing the audit expectations gap. For example, in a letter to the editor of the *Journal of Accountancy*, Fogarty (1994, p.11) argues that:

“Teaching investors that audits do not provide the assurance they expect would be difficult and expensive. But more important, the fact it has not been accomplished by now strongly suggests it cannot be done... If investors see the audit function clearly in terms of the assurances it does not provide, they may not value accountants’ services as highly as they do now. This eventually could erode the social consensus behind the necessity for external audits. Those who bemoan the expectation gap should consider it may be both inevitable and important.”

Lee *et al* (2009) likewise considered education as not being a practical way to address problems of the audit expectations gap since the public may neither have attended universities nor done any auditing courses in colleges or universities. Darnill (1991) critically pointed out that it was difficult to educate the public through mass communication. This was because auditing was considered as a complex subject, which therefore did not lend itself to gross simplification for the benefit of the general public. Darnill (1991) furthermore claimed that there existed a general lack of public interest in the work of auditors such that despite providing educational material on the subject, the public may still choose to ignore the information given.

Disclosing materiality levels used in an audit engagement was another recommendation aimed at narrowing the audit expectations gap. Materiality is a fundamental concept in auditing that is applied throughout all the stages of an audit, namely the planning stage, the execution stage and the completion stage. However, materiality levels were, up to recently, never disclosed in the auditor’s report. The failure to disclose materiality thresholds may cause users to have unreasonable expectations, thus further fuelling the audit expectations gap debate (De Martinis and Burrowes, 1996). This was because there may be stakeholders that perceived financial statement audits by external independent

auditors to be tantamount to a guarantee or certification that the financial statements were a hundred per cent correct. Houghton *et al* (2011) concluded that some widespread understanding that materiality levels existed can reduce the audit expectations gap by removing the notion that the audit is a comprehensive guarantee of the transactions and financial representations made by management. Recent research on the subject of materiality also concluded that the concept of materiality was one that was largely misunderstood by investors and that additional auditor disclosures related to materiality may therefore contribute positively (Gray *et al*, 2011; Coram *et al*, 2011; Houghton *et al*, 2011).

Most of the studies carried out on the audit expectations have adopted a quantitative approach and have been conducted in developed or large countries, typically Western economies. Limited attention has been given to external factors related to the audit environment that can also influence the expectations gap. Factors such as political, economic and social ones, which can influence and shape the audit profession, may differ from one country to another. The recommendations adopted for one society may therefore not be successful in another. According to Zaid (1993), a society's values and expectations should guide the development of auditing standards and regulations with the objective of ensuring that the audit profession achieves its objective of providing assurance to the users. Thus, in order to "solve" the expectations gap issue, Eldarragi (2008) considered it essential to understand how auditors and users perceived the meaning of audit and the role of auditors in the context of the research setting under study.

The review of literature has shown that extensive research has been conducted on the audit expectations gap – yet, a gap still seems to exist. Very little attention has been dedicated to another element that may in fact be contributing to a wider phenomenon, namely the financial statements expectations gap, and this gap may be even more pronounced within the context of small island economies.

2.4 THE OBJECTIVE OF FINANCIAL STATEMENTS

Accounting, or rather account keeping, is not a recent phenomenon. It has existed, in some form or other, for many years, albeit in a much unsophisticated manner, and certainly in a more rudimentary form when compared to today. The very earliest origin of accounting can be traced to thousands of years ago. In fact, according to Hendriksen and Van Breda (1992, p.38):

“Sophisticated accounting systems appear to have been in place in China as early as 2000 BC and tantalising references indicate a familiarity with double-entry bookkeeping in Rome at the beginning of the Christian era. More controversially, some even claim that the Romans were familiar with the concept of depreciation”.

Brown (1905, p.94) describes the initial form of account keeping as being “nothing more than a series of unconnected jottings related to those portions of business on which it would have been unwise to rely on memory alone”. The evolution or transition from being memorandum records to containing more information on amounts paid and received saw the birth of book-keeping in its early stages. Initially, the concept of permanent capital did not exist since the early venturing expeditions done by individuals or entrepreneurs were based on the repayment of the original capital and profits, where applicable, to the venturing merchants. It was with the creation of corporations that the concept of a permanent capital started. A very commonly mentioned example was the issue of capital for a term of four years by East India in 1613, which although not being of a permanent nature, represented a step in the direction of permanently invested capital. The change from the periodic settlement for ventures to the use of permanent capital created the need, coupled with the resulting difficulties, of determining profit for a period. In other words, a periodic calculation of profits (Littleton, 1933) was now required.

Accounting was “originally designed for the purpose of providing internal control of business affairs by private owners” (American Accounting Association, 1936a, p.1). At the time, the main objective of preparing accounts seems to have been stewardship accountability, wherein accounts were considered as encompassing information useful in assessing the agent’s stewardship of the principal’s resources. In fact, agency relationships have links to the origins of accounting. Yamey (1962, p.15) stated that:

“The origins of accounting and indeed of written records are probably to be found in the need of an “accounting” officer to render a statement of money and other assets received in his charge on behalf of his employer, or disbursed on his behalf. There was need for a check on the honesty and reliability of subordinates”.

The reference by Yamey (1962) to a check on the honesty and reliability of subordinates implies that accounts can also serve the purpose of preventing and detecting theft and fraud. The whole purpose of accounting, in its early days, was therefore not to “measure the rate of profit or loss but to keep accurate records of acquisitions and outgoings, in money and in kind, and to expose any losses due to dishonesty or negligence” (de Ste. Croix, 1956, p.38). As Higson (2003, p.41) contends:

“The earliest uses of accounting data were in what we would now call a management accounting setting, and accounting could be classified as an internal control. As early accounting was used for stewardship purposes, it can be seen that in the early days, stewardship and management accounting were linked.”

Accounting has come a long way since those early days. Both financial markets and the business environment have evolved dramatically over the years, and accordingly, accounting has likewise evolved to meet the information needs of a wide range of users. In fact, accounting standard-setters have over the past fifty years placed increasing emphasis on the decision-usefulness of the financial statements. Prior to this, the situation was very different. For example, Littleton (1953, p.25) considered that:

“Accounting is the instrument used to treat a mass of enterprise facts so that the flow of transactions becomes intelligible... It is hard to overestimate the contribution to understanding made by compressing a mass of facts and by setting up the resulting data in ways that permit comparisons to be made.”

Even earlier, the American Accounting Association (1936b, p.188-189) stated that “accounting is...not essentially a process of valuation, but the allocation of historical costs and revenues to current and succeeding fiscal periods.” The earliest approaches to defining the objectives of financial statements were “focused on the computation and presentation of net income resulting from specific realisation and matching rules with a

balance sheet that relates the current period to future periods” (Hendriksen and Van Breda, 1992, p.126). These views of accounting, however, no longer seem to hold sway in today’s contemporary accounting and business world.

According to Zeff (2013), the modern accounting literature on the objectives of general purpose financial statements began in earnest once the decision-usefulness view entered the accounting literature. Prior to this, literature focused on the use or the purpose of financial statements, without a specific reference to the term “objectives”. Although it may not have been specifically stated, there was a reasonably clear understanding of the objective of financial statements in terms of stewardship. In fact, Skinner and Milburn (2001, p.586) referred to the “the strong tradition in accounting history to the effect that the purpose of accounting is to report on the stewardship of management”. Watts and Zimmerman (1986) focused on the need for shareholders to receive control information for monitoring and rewarding managers’ performance so that it does not deviate from shareholders’ expectations. Williamson and Lipman (1991, p.364) stated that the “interdependence of stewardship and accounting was the rationale for explaining the demand for accounting numbers and auditing until well into this century”. The implication of the reporting to shareholders on stewardship was also referred to by the Cohen Committee (1978) where the primary purpose of financial statements was stated as being to convey financial information in a form that can be assimilated by shareholders and creditors.

In the 1990s, there was the Statement of Principles debate in the UK. Decision-usefulness was set out by standard-setters as being the basis of their conceptual framework. The focus of standard-setters at this point in time was on decision-usefulness. This stance was however heavily criticised. Yet this criticism seemed to be ignored and standard-setters stuck with decision-usefulness as the basis of the conceptual framework. Table 2.1 illustrates how the objective of financial statements has changed in recent years, with the most recent objectives being presented first.

“To provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.” (IASB, 2010, p.6)

“The objective of financial statements is to provide information about the reporting entity’s financial performance and financial position that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions.” (ASB, 1999, Ch.1)

“The objective of financial statements is to provide information about the financial position, performance and financial adaptability of an enterprise that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions.” (ASB, 1995, para.1)

“The objective of financial statements is to provide information about the financial position, performance and financial adaptability of an enterprise that is useful to a wide range of users in making economic decisions.” (ASB, 1991, para.12)

“The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions” (IASC, 1989, para.12)

“The committee defines accounting as the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by the users of the information.” (AAA, 1966, p.1)

Table 2.1: The changing objective of the financial statements – building on shifting sands? Higson (2013, p.238)

It would appear, *prima facie*, that the accounting standard-setters have struggled to specify in a clear definitive manner the objective of the financial statements. Rather than being a principle cast in stone at the start of the standard-setting process and serving as the underlying foundation of accounting standards, the objective of financial statements is one that has been changing, with standard-setters focusing on different facets over time.

Furthermore, the current IFRS Conceptual Framework (the first definition in Table 2.1) focuses on the users “providing resources to the entity”. However, in practice,

shareholders and potential investors only provide resources to an entity in the course of a new share issue. Indeed, many investment and/or divestment decisions are based on the trading on shares in the secondary market (“second-hand shares”) and it is therefore clear that these decisions do not result in the provision of resources to the reporting entity (Higson, 2013). In an IFRS Discussion Paper entitled “A Review of the Conceptual Framework for Financial Reporting” issued in 2013, the objective of financial statements with respect to presentation and disclosure was again modified and stated as being the provision of:

“summarised information about recognised assets, liabilities, equity, income, expenses, changes in equity, and cash flows that has been classified and aggregated in a manner that is useful to users of financial statements in making decisions about providing resources to the entity.”
(IFRS Foundation, 2013, p.12)

The extensive focus on decision-usefulness of financial statements has resulted in an increased emphasis being made on the relevance and reliability of the data in the financial statements as a basis for the economic decisions of the users. This greater importance being attached to relevance and reliability led to the downplaying of what were the fundamental accounting concepts, a key one being prudence. Prudence was one of the fundamental concepts historically used in the preparation of financial statements. The maxim “never anticipate your profits but always anticipate your losses” was frequently taught in basic book-keeping lectures. Today, the term “prudence” is not identified as an underlying assumption in the IASB Conceptual Framework for Financial Reporting, nor is it referred to in IAS 1 *Presentation of Financial Statements*. Also, the focus of financial statements has moved from the income statement (emphasising income and expenditure) to the balance sheet (with the emphasis being on the assets and liability approach). This approach has resulted in the rise of “comprehensive income” which increasingly focuses on the use of fair values and mark-to-market accounting in the preparation of financial statements.

Thus, from being a profession historically associated with “prudence” and, to a certain degree, “conservatism”, the accountancy profession was all of a sudden projected at the forefront of innovative financial disclosure. Although the “prudent” approach may have

understated corporate performance, it probably limited the risks associated with the financial figures. The comprehensive income approach attempts to “capture” financial performance in a wider sense, but this at the danger of increasing the risks associated with financial data. This is a consideration that, according to Higson (2010), does not seem to have received much attention.

The above would seem to follow from the idea that “accounting repeatedly has been regarded as the theory and practice of measurement of income and wealth” (AAA, 1971, p.47). Sterling (1979, p.191) defined income as “the difference between wealth at two points in time after adjusting for consumption for individuals or investment for firms”, and he also opined that “since income and wealth are inextricably entwined, an incorrect measure of one yields an incorrect measure of the other and vice versa” (Sterling (1979, p.196). In economics “wealth” is an extremely difficult concept to define and thus measure. Moonitz (1961, p.12) considered that accountants had “translated the “wealth” of economics into the “assets of accounting”. Using this interpretation of “wealth”, one may be inclined to consider that the balance sheet, which reflects the assets owned by the business and liabilities due, showed the net “wealth” of the business. However, Canning (1929) asserted that “scarcely any two amounts representing asset classes in a balance sheet can be added, legitimately, to obtain a measure of the wealth of an entity in respect of those classes; and a fortiori a balance sheet total for assets cannot be taken as a measure of aggregate wealth” (Chambers, 1998, p.42).

It could be argued that many of the issues associated with financial reporting arise as a result of the problems of specifying the objective of the financial statements. Standard setters may be exacerbating the expectations gap by widening the objectives of financial statements to a degree that cannot be met by the profession. A user of financial statements would be legitimate in expecting that financial statements are “fit for their purpose” – but what is the consequence if the “purpose” consists of various objectives that, at times, could also be conflicting ones?

The recent focus of standard-setters on future decision-making has resulted in the objective of financial reporting being considered as one relating to resource-allocation

decision-usefulness. This focus aims to change accounts from being “a report on past performance” into “an instrument for predicting future cash flows”. It also “seems to suggest either that backward-looking accounts can help predict the future or that financial statements themselves ought to be more forward looking” (Myddelton, 2004, p. 28). Under this objective, the provision of information that is useful to users in making investment, credit and similar resource allocation decisions became the primary focus of financial statements. With the advent and development of sophisticated capital markets, a new focus for financial reporting evolved – one related to cash flow generation that would assist decision making for the primary user group (the providers of capital) as identified in the IASB 2010 Conceptual Framework for Financial Reporting. In a comment letter received on the IASB’s and FASB’s Discussion Paper on the Proposed Joint Conceptual Framework, the Corporate Reporting Users Forum remarked that “history matters, because it allows users to gain a closer understanding of how an entity generates returns, and therefore provides users with key tools in assessing what future returns may be” and that “unless stewardship is retained as a separate objective, financial reporting risks becoming excessively focused on forward-looking predictions and estimates of future cash flows” (ASB, 2007, p.17).

Similar criticisms on the emphasis on decision making had also been in previous decades at the time of amending the objective of financial statements by standard setters. For example, Page (1991, p.31) opined that “the ASB should acknowledge that the decision-usefulness concept gives meagre guidance, and should concentrate on setting standards which enhance the stewardship or control function of accounting”. Anthony (1983, p.15) advocated that “financial accounting should focus on the entity as such, rather than on the interest of equity investors in the entity, as is the present focus”. This “present focus” noted by Anthony (1983) is still prevalent today, more than thirty years later, and the position is further exacerbated by the provision of forward looking information to users. Higson (2013, p.243) questioned the logic behind the argument that “just because some users take decisions based on the financial statements, the objective of the financial statements is to enable users to take decisions”, commenting that such an argument would appear to be “circular reasoning”.

Higson (2010) also argued that the focus of standard-setters on future decision-making was a dubious basis to underpin the production of financial reporting standards. This was because future decision-making is based on the premise of “unspecified users taking unspecified decisions, at unspecified times, with unspecified success” (Higson, 2010, p16). This resulted in a situation where standard setters may be basing standards on “shifting sands that will not provide a firm foundation for the production of a consistent and coherent set of standards” (Higson, 2010, p16). Consequently, there was the risk that financial statements may mean all things to all people – with an overreliance on the external auditors to carry out the audit work to see that things were right (Higson, 2010).

Decision-making also demands consideration of a number of factors that are not given consideration in a set of financial statements prepared in accordance with financial reporting frameworks such as IFRS. Examples include information on economic climate, political developments, an organisation’s competitors, expected technological developments and projected demographic changes. Future decisions should be based on estimates of what is possibly or probably going to happen in the future, rather than what has already happened in the past. It is also questionable, in today’s highly sophisticated business world, the extent to which investors actually await the publication of audited financial results in order for them to make economic decisions. Prior research suggested that annual reports were not a key information source for professional investors and analysts, particularly as they contain out-of-date and backward-looking information. Such professional users were found to rely on private disclosure channels, which provide information in advance of annual report publication (Barker, 2001; Campbell and Slack, 2008; Holland, 2006; Marston and Straker, 2001; McInnes *et al*, 2007). Furthermore, short term investors were concerned about making short term gains on price movements and such decisions were typically made in anticipation of the publication of audited results. Additionally, the increased regulatory pressures on listed entities to make regular public company announcements and interim statements made it very likely that any relevant information for decision-making would be made available to the investor ahead of the issue of audited results.

Another facet of the decision-usefulness of financial statements is the legal aspect related to auditor's liability. The UK Company Law Review Steering Group (2001) stated that:

“auditors have no liability to existing shareholders who rely on their report for investment decisions (for example to buy or sell shares), or actual creditors of the company who may make similar decisions about maintaining or withdrawing credit, or potential investors whether of equity or debt, or other potential creditors (for example, trade creditors), who rely on the audit report for a view of the financial position of the company.”

In a significant UK court case in 1990, one of the Justices said in the Law Lords' decision in *Caparo Industries plc vs Dickman and others* (Judgment, 8 February 1990, p.48) that:

“There is nothing in Part VII which suggests that the accounts are prepared and sent to members for any purpose other than to enable them to exercise class rights in general meeting... Advice to individual shareholders in relation to present or future investment in the company is no part of the statutory purpose of the preparation and distribution of the accounts.”

It is therefore not surprising that following another court case, the *Bannerman* case in 2003, auditors started to add a paragraph in the audit report advising that audit work was undertaken as to enable them to express their opinion solely to the members of the company, and for no other purpose. In addition, statements were included to specifically exclude liability by stating no responsibility is accepted or assumed to anyone other than the company and the company's shareholders as a body for the content of their report.

2.5 WHAT DO FINANCIAL STATEMENTS REALLY SHOW?

The past two decades have witnessed increased attention being dedicated to corporate governance. The recent financial crisis has been a major one and it has nearly resulted in the collapse of the financial sectors of the Western world. Its effects have been so significant that it has resulted in serious questions over the whole idea of corporate governance. It also raised criticisms over the appropriateness of certain regulations, such as Sarbanes-Oxley. Various reviews have been conducted following this crisis (e.g. the Walker Review (2009) of banks and other financial institutions); however, suggestions

for specific changes were limited (e.g. FCR, 2010). Therefore, one has to consider whether the real root cause of the problem has in fact been identified.

The financial statements of a company are the public face of the reporting entity. As such, they are used as a surrogate indicator of corporate performance. Financial statements are generally considered to represent the “face” of the company on all issues related to overall financial performance. They are often uploaded on company websites to provide interested parties with information on the financial health of the entity and act as a communication tool with external stakeholders. However, if the contents of the complex financial statements are not understood by stakeholders, then the prime means of holding the directors accountable may be problematic. This understanding requires stakeholders to fully appreciate the scope, assumptions and limitations of the financial statements. It is critical for stakeholders to remember that financial statements are only a surrogate for corporate performance. The danger is that this is often forgotten and the accounting numbers therefore become an end in themselves. Thus, the question needs to be asked: “What do financial statements really show?”

Higson (2003) argued that standard-setters considered the objective of the financial statements to be predicting the future, taking decisions, judging the stewardship of management and assessing the performance (past and potential) of the reporting entity, questioning whether these objectives were really achievable or realistic especially with just one set of figures. Higson (2003) therefore opined that the failure of the accounting standard-setters to be clear about the objective of the financial statements helped to exacerbate a financial reporting expectations gap. According to Higson (2003), a financial reporting expectations gap existed and this was made up of two elements: one being the audit expectations gap; and the other being the expectations gap relating to the financial statements (see Figure 1.1 in Section 1.1). There has been much discussion of the audit expectations gap, as already evidenced in Section 2.3 describing the prior literature on this subject. There is, however, limited discussion on the second element – the financial statements expectations gap. According to Higson (2010), compared to the recognition given to the audit expectations gap, the possibility of a financial statements expectations gap has almost been ignored.

Discussion of the financial reporting expectation gap can found in an Australian study (ASCPA and ICAA, 1994, p.iii):

“The differing perceptions of the financial reporting and audit function - the so-called ‘Expectations Gap’... goes to the very heart of financial reporting in this country [Australia]. It is vital that this important issue is given a frank and open airing to clear any misconceptions and ensure both preparers and users of financial reports fully understand the reporting and auditing process.”

An *Accountancy* (1993) editorial also suggested that the expectations gap could comprise two components – the “audit expectations gap” and the “financial statements gap”. It asserted that “this expectations gap is a complex phenomenon and it is caused as much by financial reporting problems as it is by auditing ones” (*Accountancy*, 1993, p.1). This point was also reported by Nolan (2010) when, during a 2010 audit forum hosted by the Chartered Accountants Ireland, a number of contributors opined that the first issue to be addressed in relation to confidence in the financial statements should be the financial reporting standards framework under which financial statements are prepared. The view was expressed that there is an “an accounting expectations gap as well as an audit expectation and this should be addressed by standard setters” (Nolan, 2010, p.10). Reference was therefore made to an “accounting expectations gap” as opposed to the traditional “audit expectations gap”. Another matter that was raised was the ability of general purpose financial statements to meet the needs of all stakeholders simultaneously. In this respect, a suggestion was made at this forum that different, but appropriately tailored reports, ought to be prepared by companies addressing the different information needs of particular stakeholders.

Lee and Tweedie (1977; 1981) found that financial statement users lacked comprehension of some fundamental aspects of accounting. Liggio (1974) tried to explain why this financial statements gap existed. He explicated that users viewed the financial statements, because of the use of numbers, as having a degree of exactness, when in reality they do not. This is due to the fact that in our early days of education, we are taught that “two plus two equals four” (Liggio 1974, p.28). Numbers are precise and with no margin of error. Since financial statements are a composite of numbers, the users may think that they have that level of precision, accuracy and definitiveness (op. cit.:28). Phillip

Loomis's view concurred with Liggio's that there is a "widespread public misunderstanding of the function and limitations of accounting" (cited in Liggio, 1974, p.29).

Jenkins, during an interview with Singleton-Green (1990, p.82), stated that the "accepted conventions of communicating information through financial statements imply a degree of precision that clearly doesn't exist". In the same interview, Tegner (Singleton-Green, 1990, p.82) used the historical cost as a scapegoat for this ignorance gap when he argued that historical cost accounts imply that everything in them relates to something which has actually happened and is definitive. In his opinion, the solution would be to:

"tell people more about the processes which have to be gone through in preparing accounts, the subjective processes and the judgments about the future which have to be made" (Tegner in Green Singleton, 1990, p.82)

The 2006 Discussion Paper titled "Proposed Joint Conceptual Framework for Financial Reporting" also advocated the fact that users of financial statements need to be aware of the characteristics and limitations of the information contained therein. It also accepted that:

"to a significant extent, financial reporting is based on estimates, rather than exact measures, of the financial effects on entities of transactions and other events and circumstances that have already happened or that exist" (IASCF 2006, OB15).

Surely, it is therefore only with the recognition of the scope and limitations of the financial statements that "the debate about how to communicate corporate performance and risk can begin" (Higson, 2003, p.13.).

2.6 THE UNDERSTANDABILITY OF FINANCIAL STATEMENTS

The International Accounting Standards Committee (IASC), which is the IASB's predecessor, issued its conceptual framework titled "Framework for the Preparation and Presentation of Financial Statements" in 1989. In this framework, it identified understandability, together with reliability, comparability and relevance, as the four

principal qualitative characteristics of useful information. The 1989 conceptual framework only included a brief paragraph on understandability, without including any basis for conclusions that elaborate further to explain the justification for its inclusion. It also did not provide a clear definition of understandability, but it only highlighted the importance that the information included in financial statements was readily understandable by users. In this regard, users were expected to have a basic knowledge of accounting and business and a willingness to analyse the presented information. According to this framework, relevant information of a complex nature should be included in the financial statements, notwithstanding the fact that it may be hard to grasp by the average user (IASB, 1989). In other words, financial reporting should not exclude relevant information merely because it is not easy for some to comprehend.

The IFRS Conceptual Framework for Financial Reporting identified the qualitative characteristics of useful financial reporting. Financial information is considered as being useful when it is relevant and when it represents faithfully what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable. The IFRS Conceptual framework has therefore split the qualitative characteristics of useful information into fundamental and enhancing qualitative characteristics. According to the IASB:

“financial information without the two qualitative characteristics of relevance and faithful representation is not useful, and it cannot be made useful by being more comparable, verifiable, timely or understandable. However, financial information that is relevant and faithfully represented may still be useful even if it does not have any of the enhancing qualitative characteristics”
(IASB, 2010: BC3.10).

Understandability has therefore been “demoted” to an enhancing qualitative characteristic in the IASB Conceptual Framework. A number of representations to the discussion paper issued by the IASB in 2013 had expressed their concerns that understandability was not being given due attention and that it should be “promoted” back to a fundamental qualitative characteristic, or alternatively declared as an objective of financial reporting (IASB, 2015). Nonetheless, the IASB opted not to make any changes based on the fear

that preparers of financial statements may possibly leave out relevant information solely because it may be too difficult to understand by the average user.

Understandability is clearly fundamental for the financial “message” of financial statements to be effectively communicated to the reader of the financial statements. Unfortunately, one problem in the financial reporting world is that people with limited financial knowledge can look at a set of financial statements, attempt to interpret the numbers and derive conclusions therefrom. This may have been fairly possible some decades ago, but probably it is no longer the case today.

The IASB Conceptual Framework presumes that the users of financial statements have a sufficient reasonable knowledge of business and economic activities to be able to read and understand financial statements. This presumed knowledge is fundamental to ensuring that the “message” of the financial statements is understood by the users. However, it is questionable whether the private investor has sufficient expertise to be able to understand today’s increasingly-complex financial statements. As the financial world has become more complex, financial reporting had to mirror such changes by introducing new techniques and demanding more disclosures to cater for such developments. Accounting for complex financial instruments and the increased use of fair value accounting and financial risk management techniques are just a few examples of developments that have radically changed the world of accounting. Such developments may have left behind most private investors for whom accounting may now really have become something like a mysterious black box.

Financial reporting disclosure requirements have responded to changes in the business environment by expanding disclosure requirements considerably. Disclosures, or “notes to the financial statements” as they are commonly referred to, were originally primarily related directly to further explaining certain line items included on the face of the primary financial statements. They included, for example, breakdowns of certain figures into more disaggregated data to help the user of the financial statements understand movements and changes in financial position. They also typically included qualitative information, such as narratives on certain events or circumstances affecting the entity.

Today's accounting standards demand significantly more than this – disclosures of assumptions, models, alternative measurement bases, sensitivity analysis and sources of estimation uncertainty amongst others. As commented in the Discussion Paper entitled "The evolving nature of financial reporting" (January 2011, p.6) issued by IFAC, "disclosures have become the balancing item in the calculus of how to provide credible, decision-useful information". It is clear that these trends in financial reporting do not only pose challenges to the preparer of financial statements who must ultimately prepare and support the new disclosures. They also bring forward serious challenges to the users who must try to somehow identify the importance of the disclosed information when making economic decisions on the basis of the financial statements. Furthermore, there is also an audit consideration to this. ISA require the auditor to audit disclosures and therefore assess the risks of material misstatement at the assertion level for disclosures. The extent and nature of information being disclosed raises practical issues for auditors in their process of collecting sufficient appropriate audit evidence. These issues include the difficulty, in practice, of obtaining sufficient appropriate audit evidence in relation to some disclosures. In some cases, certain disclosures may not actually be auditable. Some information may not even be derived from the accounting system and may also include forward-looking information, disclosures of estimation uncertainty and models. This further exacerbates the position for the auditor in practice when performing audit work.

The IASB (2016) "Better Communication in Financial Reporting – making disclosures more meaningful" identified three concerns about information in financial statements: not enough relevant information, too much irrelevant information and information communicated ineffectively. In fact, the IASB acknowledged the risk that the present situation may result in investors overlooking relevant information or even failing to identify relationships between pieces of information in different parts of a company's set of financial statements (IASB, 2017b). This can result in "uncertainty around what investors perceive are the company's prospects" (IASB, 2017b, p.4).

The difficulty in comprehending the message contained in financial statements is not, however, a recent phenomenon. Briloff (1967a) quoted a former Commissioner of the Securities and Exchange Commission as saying that a lay reader who can read perfect

English and an orderly presentation of financial data would still end up without a comprehension of the message sought to be conveyed. Way back in 1964, Leonard Spacek, former CEO of Arthur Andersen launched a tirade against the profession when he said:

“How my profession can tolerate such fiction and look the public in the eye is beyond my understanding....my profession appears to regard a set of financial statements as a roulette wheel to the public investor and it is his tough luck if he does not understand the risks that we inject in the accounting reports” (Spacek, 1964, p.24)

Recent developments have therefore exacerbated an issue with financial statements that had its origins many decades ago.

2.7 THEORETICAL FRAMEWORK: COMMUNICATION THEORY

This Section presents the theoretical framework underlying the study.

Communication has a vital role to play in all social contexts. Communication is concerned with “messages, information, meaning and symbolic activity” (Putnam and Cheney, 1985, p.131). According to Merkl-Davies and Brennan (2017), in the case of business organisations, communication plays a crucial role in informing external parties about outcomes and events, as well as in managing relationships with external audiences, including shareholders and other stakeholders such as the media and the general public. Briloff (1967b) stated that every social context required communication between those who were put into a position of responsibility and those to whom they were presumed to be accountable. Those who were in positions of responsibility must be prepared to answer questions about what they were doing. At the same time, those who delegated responsibility must prepare themselves to ask vital questions to those persons to whom they have delegated responsibility.

Accounting is often referred to a “communication process” or as a “language” (the “language” of the business world). Communication is therefore central to the accounting function. Indeed, as stated by Littleton and Zimmerman (1962, p.46), “it is noteworthy

that the tool of analysis that we call accounting has always had communication as an objective". The vital role of communication was also referred to by Carey (1965, p.117) who stated that "the idea that the accounting embraces the measurement and communication of all financial and economic data is a breakthrough in the thinking of certified public accountants about themselves". Furthermore, Carey (1965, p.53) advocated that "people who have an interest in resources are in various stages of remoteness from them and from the factors affecting them" and "the greater this remoteness, the greater the need for communication of data". Littleton (1953, p.15) stated that "clearly, accounting is an important means of communication in modern industrial society" and that "to serve this purpose well, accounting information must be skillfully compressed out of a mass of facts" and must be "dependably factual, informative and reliable". Chambers (1966, cited in Lee, 1982) drew attention to the need for the clear communication of accounting information almost five decades ago. Lee (1982) stated that it is not sufficient to only focus on measuring the financial performance and financial position because the information needed to be communicated to a wide range of audiences. In fact, Lee (1982, p.152) stated that:

"Arguably, accounting is as much about communication as it is to do with measurement. No matter how effective the process of accounting quantification, its resultant data will be less than useful unless they are communicated adequately".

The AAA (1966, p.13) emphasized the vital linkage between accounting and communication, advocating that the development of accounting information was only one part of the accounting function and that:

"a necessary companion aspect of the function is the development of the communication process so that information can be transmitted and so that those to whom information is provided understand it and its potential usefulness".

The American Institute of CPAs Long-Range Objectives Committee identified certain "keys" to successful data communication. Carey (1962) stated that "in any successful communication, a meeting of minds must exist between issuer and user as to the meaning of terms". In order for this "meeting of minds" to occur, the following conditions were identified as being necessary: (i) an understanding of the issuer and the user about the

standards for measurement and summarization; (ii) the user's requisite knowledge and skills to carry out the steps to prepare the communication; (iii) an absence of bias in the communication; and (iv) the communication must be intelligible to the user. A mutuality of understanding is described as being "patently essential" by Briloff (1967b, p.27). As early as 1936, the American Accounting Association (1936a, p.2) identified the need for accounting statements to be "intelligible to the layman of sound mentality and substantial acquaintance with business affairs. If accountants are to speak only to accountants, it seems hardly necessary that they speak at all". The American Accounting Association (1936b, p.187) also stated that:

"it should be possible for a person moderately experienced in business and finance to examine such statements with the expectation of deriving from them the basic facts on which at least tentative business judgments may be premised".

Discussion on communication theory in the accounting and auditing world is not new (see for example, Barnett, 1989; Bedford and Baladouni, 1962; Parker, 1986). To the Committee charged with the preparation of a Statement of Basic Accounting Theory, accounting was the process of "communicating economic information to permit informed judgements and decisions by users of information" (AAA, 1966, p.1) such that accounting was a "measurement-communication system". However, despite the existence of literature that refers to the communicative dimension of accounting, the emphasis over the years has been on decision-making/decision-usefulness and the prediction of future cash flows, and these have served as the basis for the construction of a conceptual framework for financial reporting. Communications theory has not therefore been referred to underpin the construction of such framework. Indeed, concepts from communication theory may provide a framework within which to understand the communication associated with financial reporting and provide a foundation from which to prescribe effective approaches to understand the root cause of the financial statements expectations gap, thereby addressing the missing link in the chain.

Communication has been cited as one of the fundamental postulates of auditing (Schandl, 1978), therefore playing an important role in the audit or assurance function. Assurance reporting is a communication process. A study by Parker (1986) was founded upon the argument that corporate annual reports represent a process of mass communication.

Parker (1986, p.29) quoted a practitioner saying that “most accountants have probably never thought of themselves as being in the communication business”. This leads to a worrying concern that there may have been a lack of official recognition of the importance of communicating through financial reports.

Theories on communication and communication concepts from areas of study such as linguistics, information theory, psychology and sociology can provide useful insights to the financial statements expectations gap. One of the earliest and most influential communications models was that developed by Lasswell (1948) who identified that a convenient way to describe an act of communication was by answering the following questions: “who”? “says what”? “in which channel”? “to whom”? “and with what effect”? Lasswell (1948) proposed the first model of communication as being a one-way method en route from one individual to another.

Communication theory (Lasswell, 1948; Shannon and Weaver, 1949) splits the communication process into the message, the means of communication and whether the recipient receives the message that was sent. Shannon, an engineer by profession, was in fact studying how to transmit electrical impulses from one place to another in the most efficient way, and he concluded that this mechanistic approach could be adapted for interaction between individuals. In terms of applying this to financial reporting, it would mean identifying the message/s that the directors were trying to communicate. The annual report (including the financial statements, the Chairman's statement and other explanatory information) could be viewed as the means of communicating this message. The users' understanding of the reporting process, their interpretation of the financial statements and any related documents would determine whether they received the message the directors were trying to send. Therefore, in utilising communication theory, the critical starting point would be the identification of the message/s that the directors were trying to communicate through the financial statements. Higson (2003) illustrated the application of communication theory to the financial statements as follows:

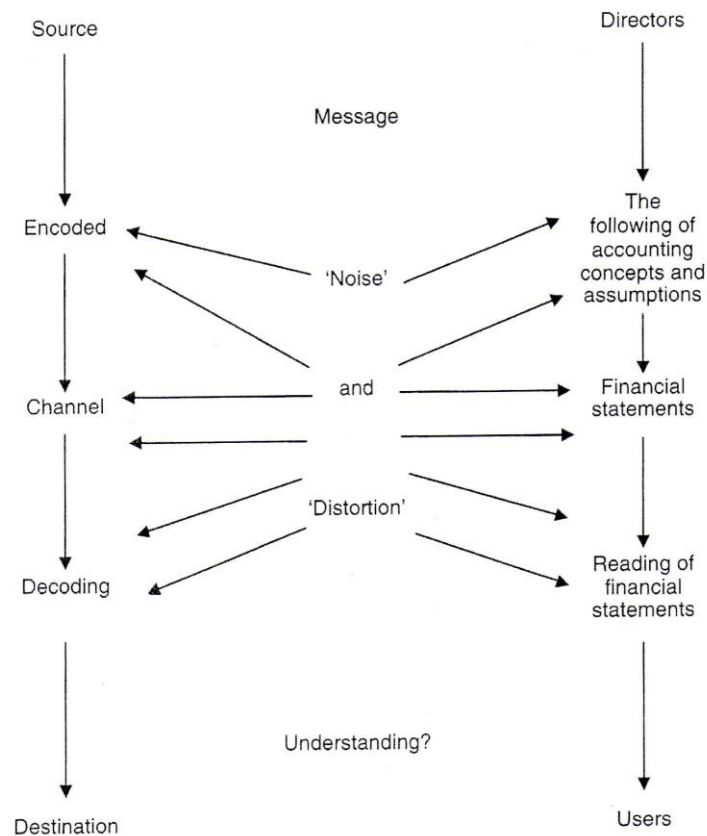


Figure 2.2: The application of communication theory to the financial statements (Higson, 2003, p.30)

Fiske (1990) described two dominant methods of analysing the communication process: the process and the semiotic schools of thought. Process analysis views communication as a one way linear phenomenon; on the other hand, semiotic analysis identifies communication as being concerned with the production of meaning through sharing and exchange. Communication can be improved in two main ways: (a) by determining methods of better transmitting the message (the process view); or (b) by examining the context of the report and how it affects interpretation (the semiotic view).

The process school views communication as the transmission of messages. The information theory of Shannon and Weaver (1949) proposed a linear model of communication. According to this theory, information flowed from a source, through a channel, to a receiver. Under this technical view, communication was enhanced when the system carried the maximum amount of information. Information theorists focused on concepts such as “noise” (anything added to the information signal that is not intended

by the source) and “redundancy” (the repetition of key ideas and the transmission of information that is predictable). Hronsky (1998) noted that audit literature predominantly adopted the process perspective of communication. Communication problems are thought to arise from inadequate wording of the audit report (the “channel”), which does not convey the message intended by the auditor. On the basis of this rationale, the reporting process is improved by improving the transmission of the message, and including more effective wording in the report (IFAC, 2002). The process approach therefore overlooks the human factor in communication. The latter factor is duly addressed by the semiotic school.

The semiotic model of communication allows a more complex view of human communication. It sees communication as being the production and exchange of meaning (IFAC, 2002). Semiotics concentrates on the development and exchange of meanings, examining the interplay between individuals, words and images. It therefore goes beyond the process communication model. It examines how messages interact with people and it is concerned with the relationships between source and receiver which determine the meaning. This model looks at the generation of meaning by the interplay of the sender and the message, or the receiver and the message. Semiotics considers the signs themselves, the codes or systems in which the signs are organised, and the culture in which the codes exist. Under this school of thought, the receiver of the report plays a more active role in the process. The receiver brings in his experiences to bear in creating the meaning of the text. The semiotic approach can be considered to be more relevant to examining the financial statements expectations gap as it also focuses on interpretations made and inferences drawn by those receiving the information being communicated.

Another model of communication is that proposed by Westley and MacLean, which can be seen in two contexts, interpersonal and mass communication. The difference between interpersonal and mass communication is feedback. According to Westley and MacLean (1957), in interpersonal communication, the feedback is direct and fast; in mass communication, the feedback is indirect and slow. Westley and MacLean contend that communication does not begin when one person starts to talk; it starts when a person responds selectively to the physical surroundings. Communication therefore begins only

when a person receives messages from surroundings. Each receiver responds to the message they received based on their object of orientation.

Bedford and Baladouni (1962), who developed the communication theory approach to accountancy, opined that viewing accountancy as a communication process provided a clearer picture on the nature and scope of the accounting function in an economic system. In describing a communication theory, Bedford and Baladouni (1962, p.658) quote Hylton (1962, p.27) as stating that the problem of accounting theory was “not in the existing differences of opinion but in the lack of any sense of direction in which we should be moving to make accounting what it should be”. As a consequence, Bedford and Baladouni contended that the communication theory approach to accountancy was one way of providing the desired “sense of direction”. The matrix of communication as developed by Bedford and Baladouni (1962) is reproduced in Figure 2.3:

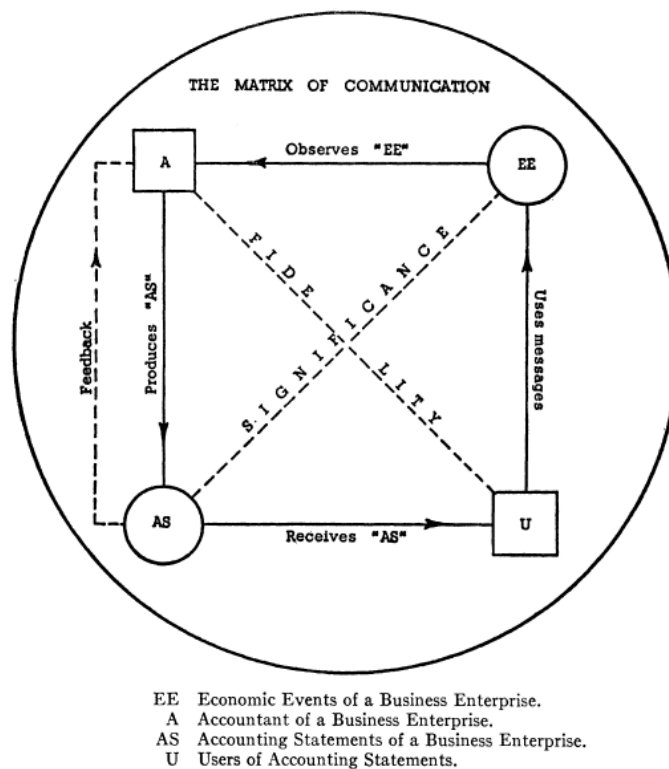


Figure 2.3 The matrix of communication (Bedford and Baladouni, 1962, p.653)

Given a purpose for communicating, the communicator faces two issues: content and media of communication. In other words, the communicator has to determine “what” and “how” to communicate. To achieve the “what” content, the communicator must select

his material from what is available for observation. To achieve the “how” aspect, the communicator must select the technical means of producing the message. In accountancy too, communication includes these two dimensions. The observational dimension includes receiving information about an entity’s economic events, interpreting the information and selecting which information is to be communicated. The productional dimension includes encoding the information as message and transmitting the encoded message to the destination. Communication is therefore not confined to the productional dimension. Significance is also important. Significance relates to the degree of relevance and adequacy which accounting statements have in relation to the world of economic events. Producing highly relevant information in itself is, however, still not enough. The information must be of a high fidelity – it must be understood by the user of the accounting statements. The end users must therefore be able to interpret and decipher the accounting message and act on the basis of that understanding. It is important to remember that what is transmitted by the accountant to the shareholder is a codified message waiting for accurate interpretation by the end user. Interpreting an accounting statement means reconstructing the message the accountant has encoded. This interpretation and reconstruction may suffer from “distortion” and “noise”. In relation to accounting, “noise” relates to the technical accounting terms, whilst “distortion” refers to the users’ interpretation of financial statements.

“Noise” and “distortion” are considered to particularly hinder the communication process between the accountant and the shareholder especially when the latter is a private individual investor. The private shareholder may not have the necessary expertise and the reasonable knowledge required or assumed by standard setters to interpret correctly the message and understand the technical accounting jargon and concepts. On the other hand, institutional investors often have access to financial expertise, which is often not available to other investors and so such institutional investors are much less prone to the negative effects of “noise” and “distortion”. This situation does not, however, according to Brown and Wilkinson-Riddle (1994) mitigate the responsibility of the profession to provide information suitable for the inexpert minority of shareholders.

Audit reporting is the means of communication between the auditor and shareholder. However, the auditor also communicates with those charged with governance as part of

the audit process. In the case of entities having an audit committee, communication normally goes through the audit committee in its capacity as an independent monitoring body within the corporate governance structure of the entity. Matters that would typically be covered by this communication as prescribed by auditing standards include auditors' responsibilities, scope and timing of an audit, audit findings and auditor independence. In the absence of an audit committee, such matters would be taken up by the auditor directly with those charged with governance. The current auditing standards and regulations do not impose any statutory obligation for auditors to address these issues to shareholders. Shareholders, the principals engaging the auditors to attest truth and fairness, may therefore appear to be in a "disadvantaged" position when compared to management in terms of the types and nature of information being communicated. A number of studies have been conducted to examine the perceptions of auditors and users on information that needs to be communicated and reported. For example, Humphrey *et al* (1993) found that users preferred receiving information from auditors on the performance aspects of management; auditors were however reluctant to report on efficiency and effectiveness to shareholders. A study by the ICAEW (2007) reported that the surveyed shareholders considered it helpful to have more information on uncertainty and future risks, discussion of material issues encountered during the audit and their resolution, alternative accounting treatments considered and the reasons for adopting the treatment chosen, and finally more information on material or sensitive areas of judgment. According to Mock *et al* (2012, p.347), introducing such changes to the audit report would:

"provide an audit report and auditor reporting model that communicates specific information about the entity and about the audit that has been conducted. Without this basic enhancement, it seems that users will continue not to be inclined to read the audit report. Rather, they will just check whether it exists".

The adequacy of the standardised wording of the audit report has been the subject of long-standing debates and discussions due to concerns expressed relating to its form, content and communicative value (Cohen Commission, 1978; Geiger, 1993; Church *et al*, 2008). The present auditing standards demand standardisation in the form, content and wording of audit reports. Auditors do not have flexibility when drafting audit reports. Audit

information such as audit findings and the auditor's risk assessment process are not disclosed in the auditor's report. This has resulted in criticism being levied at audit reports on the basis that they "are too boilerplate and overly standardized" and that shareholders can feel excluded from what they perceive to be the "real" findings of the audit (ICAEW, 2007, p.16). As a result of this, the audit report is perceived as a "pass/fail document", being identical from one company to another and rarely understood by many shareholders due to technical audit terms used. Indeed, Church *et al* (2008) concluded that boilerplate audit reports had symbolic value but provided little communicative value since the audit report simply represented the auditor's work (symbolic value) while conveying little information (limited communicative value). Church *et al* (2008) provided evidence that in view of the deficiencies with the audit report, the market was interested in the audit report to the extent that it identified companies with deficient reports (for example, modified opinions and going concern qualifications).

The IAASB (2011) has identified an "information gap" and a "communication gap" relating to audit reporting. The information gap reflected differences between what users desired and what was available to them through the entity's set of audited financial statements and the audit report or other publicly available information. On the other hand, the communication gap reflected differences between what users desired and understood, and what was communicated by the auditor. Possible information and communications gap related to both undisclosed entity information (for example, management's business risk assessment process) and undisclosed audit information (for example, specific audit procedures implemented by the auditor in order to address the key risks of material misstatement). Mock *et al* (2012) referred to a number of initiatives and examples of audit report options under consideration by the various auditing regulatory bodies aimed at narrowing the "gaps" (for example, providing additional entity information in augmented communications by the entity, with the audit report providing assurance, commentary or attention-directing information such as emphasis of matter paragraphs). The recent global financial crisis has accordingly prompted users to demand even more information into the audited entity and its financial statements. Corporate scandals have brought up a sense of distrust to the validity of the audit report and have resulted in users of financial statements calling for more relevant information for their decision-making in

a global business environment. The Financial Reporting Council (FRC), which is primarily responsible to establish the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting and auditing, issued a revised standard in relation to the audit report applicable for financial periods ending on or after 30 September 2013. This revised standard required auditors of entities that are required to report on how they applied the UK Corporate Governance Code to also include additional disclosures, including a description of the assessed risks of material misstatement and an explanation of the concept of materiality, as well as thresholds applied. The IAASB has also duly taken duly note of these developments and has in fact included auditor reporting as a top priority, thereby initiating the auditor reporting project. The outcome of this project has been certain revisions to the auditor reporting audit standards, including but not limited to the provision of more information on how audits are performed as well as the introduction of a “key audit matters” section in the audit report of listed entity financial statements.

As an alternative to decision usefulness, and to establish the directors’ message, a more appropriate basis to underpin financial reporting may be communication theory. Effective communication with a company’s shareholders and other stakeholders is a “vital constituent of good governance” (Sir Brian Jenkins, cited in Carey, 1999, p.1). Hendriksen (1977, p.20) considered that “little has been done in applying communication theory to accounting”. Parker (1986, p.8) likewise expressed a concern that there may have been a “lack of official recognition of the importance of communicating through accounting reports by academic editors and their review boards”. Parker’s (1986, p.1) study was “founded upon the argument that corporate annual reports represent a process of mass communication”. This thesis therefore seeks to adopt communication theory as an alternative to decision usefulness to provide an appropriate basis underpinning financial reporting.

Auditor communication has also recently been the subject of a number of changes both by standard setters and also by legislative bodies, such as the EU. Such changes can be analysed into two: auditor communication at the audit firm level and auditor communication at the audit assignment level. EU legislation (regulation 537/2014)

requires audit firms to issue a transparency report on an annual basis. This report represents communication at the audit firm level between the audit firm and the public. A copy of the firm's transparency report should be publically available on the website of audit firms carrying out statutory audits of public interest entities. Such report should be published within four months after the year end of each financial year and should be retained for at least five years. The firm's transparency report contains information on the legal structure and ownership of the audit firm, a description of the internal quality control system and information concerning partners' remuneration. Recent changes in auditing standards have also impacted auditor communication at the audit assignment level. For example, with the revisions to ISA 700, the auditor's opinion is now to be presented first in the report and all sections are to have a sub-heading to enhance readability and better structure the audit report. There have also been revisions aimed at enhancing transparency and/or clarifying responsibilities – examples include the statement about the auditor's compliance with independent and other ethical responsibilities, the naming of the engagement partner and an improved description of the auditor responsibilities and key features of the audit. The audit report of public interest entities is also required to include a description of the most significant assessed risk of material misstatement, including the assessed risks of material misstatement due to fraud, together with a summary of the auditor's response to those risks.

Apart from the above changes in audit reporting, it is expected that the IASB's "Better Communication" project will result in further future changes to financial statements prepared by reporting entities. In fact, enhancing the presentation of primary financial statements is deemed central to this project. In this regard, the IASB's project specifically focuses on enhancing comparability, understandability and transparency. The Board's Discussion Paper titled "Disclosure Initiative – Principles of Disclosure" identified certain relevant principles of effective communication. These are illustrated in Figure 2.4.

Principles of effective communication suggested in the Discussion Paper	
Entity-specific	Tailoring information to a company's own circumstances.
Simple and direct	Using simple descriptions and sentence structures without omitting useful information.
Better organised	Ranking pieces of information to help users of financial statements understand their importance.
Better linked	Linking information to help users of financial statements understand the relationships between pieces of information.
Better formatted	Selecting a suitable format for the type of information companies provide.
Free of duplication	Avoiding unnecessary duplication that obscures communication.
Enhanced comparability	Disclosing information in a way that enhances comparability among companies and across reporting periods without compromising its usefulness.

Figure 2.4 Principles of effective communication (IASB, 2017b, p.6)

The IASB has also embarked on other projects that interact closely with each other, both within the “Disclosure Initiative” and also outside the “Disclosure Initiative”. For example, the “Primary Financial Statements project” is a related project that examines possible changes to the structure and content of the primary financial statements. The “Materiality implementation projects” focuses on refining the definition of “material” and clarifying its application, whilst at the same time providing guidance to help entities make judgments about whether information is material when preparing financial statements.

All these developments re-affirm the importance of communication in the financial reporting process. Indeed, it is important to ensure that the profession addresses the approach that perceives “financial statements primarily as compliance documents, rather than as a means of communication with users of the financial statements” (IASB, 2017a, p.13) – otherwise, there is the risk that the communicative value of financial statements will continue to wane, increasingly losing its relevance in the modern business environment.

After establishing the objective of financial statements and the role of communication in the financial reporting process as possible opportunities for research, the present study pursued the following research objectives within the research setting (Malta):

1. to investigate the views of auditors and shareholders on the objective of financial statements; and
2. to identify the respondents' perceptions on the message being conveyed through audited general purpose financial statements; and
3. to analyse the possible existence of a financial statements expectations gap in a small state economy, namely Malta.

2.8 CONCLUSION

This chapter has presented background theory, focusing on the expectations gap and the objectives of financial statements. The literature review has sought to address what Phillips and Pugh (2005, p.57) refer to as “what developments, controversies, breakthroughs are currently exciting or engaging the leading practitioners and thus pushing forward thinking in the subject”. It has provided a literature review on the audit expectations gap, focusing on definitions, causes and attempts to narrow the gap. As has been explained in this Chapter, the audit expectations gap has a long history. Given the significance of the expectation gap and the auditor's important role in society, it is therefore not surprising that prior research on the expectations gap is substantial. However, this is not the case with respect to the financial statements expectations gap.

The literature review that has been presented has identified a research gap relating to the financial statements expectations gap which is related to the underlying objective of financial statements and which has not been explored empirically in a small state economy. Accordingly, the next Chapter will provide information on the research setting (Malta) where the empirical evidence of the existence of the financial statements expectations gap shall be investigated. This investigation shall be carried out using communications theory as applied to the research gap in the literature that has been identified (the financial statements expectations gap).

CHAPTER THREE – THE RESEARCH SETTING: ACCOUNTANCY IN MALTA

3.1 INTRODUCTION

Malta was chosen by the researcher as an island-state to explore and investigate the existence of a financial statements expectations gap. As will be explained in Section 3.2, this choice was justified on the basis of a number of reasons: access to information, feasibility in conducting the research study and most importantly, the fact that the researcher is based in Malta, therefore having a detailed knowledge of the applicable Maltese accounting and auditing frameworks.

Section 3.3 provides background information on Malta, which like any other country has its own unique characteristics, and it also gives a brief overview to the social, political and economic environment in Malta. Section 3.4 outlines the historical development of the accountancy profession in Malta, while Sections 3.5 and 3.6 focus on the local accounting and auditing environment. Section 3.7 provides some information on the local stock market, while Section 3.8 highlights recent relevant developments at the EU level affecting the Maltese accountancy profession. Section 3.9 explains the accountancy educational paths available in Malta. Finally, Section 3.10 provides insights on accountancy in Malta based on recent research.

3.2 WHY MALTA ?

As explained in the introductory section to this chapter, the main reason for the selection of Malta as the research setting for this thesis was the fact that the researcher is based in Malta. An intrinsic knowledge of the culture, language of the island and the applicable accounting/auditing frameworks, as well as the wide diversity of business types available within a limited geographic area, made Malta the selected choice for the research study.

Various definitions have been attributed to “small islands” from time to time, emphasising different characteristics distinguishing small states from the larger counterparts. According to Crowards (2002, p.143), the most commonly applied criterion:

“...has been population size, on the basis that this provides an indication of the stock of human capital and a rough approximation of the size of the domestic market. This criterion has been supplemented at times by land area and by total income (measured as gross domestic product (GDP)).”

The World Bank (2016, p.1) defines small states as countries that either (a) have a population of 1.5 million or less, or (b) are members of the Small States Forum. Small state countries are diverse in land area, location, levels of income, and economy when compared to larger countries. Although being diverse in character, small states tend to share common grounds, typically the constraint of the “smallness factor”. These constraints include a small population, limited human capital, lack of economies of scale, a constrained domestic market, and increasing exposure to climate change and market shocks (World Bank, 2016). The Commonwealth Secretariat (2017) also uses the population size as the factor that distinguishes small states. It defines small states as sovereign countries with a population of 1.5 million people or fewer, stating that there are thirty small states in the Commonwealth, Malta being one of them (Commonwealth Secretariat, 2017).

As a small island state, Malta is seen to be highly attractive for the study of accountancy and auditing for two reasons. Firstly, although Malta is a small economy, it is a state with business types having sizes and configurations that are similar to that of larger countries, such as the UK and other European countries. One added advantage of being a small economy is that this rich variety is accessible within a small geographic area. The second reason is that the size limitations and market structure amplify the actions and conditions of the main interested parties in the accountancy and audit environment. In this regard, research in a small state may indeed uncover patterns of behaviour that are more easily discernible, whilst still being generalisable (subject to certain limitations as outlined in Section 1.6) to larger competitive settings. The major setback in choosing Malta as a

research setting is that the ensuing typology may be specific to the behaviour of small markets operating in a constrained geographical region.

The use of Malta as a research setting was also considered appropriate on the basis of the feasibility of data collection. Based on previous research studies conducted in Malta, there was a priori a reasonable expectation that co-operation from practitioners and shareholders needed to bring the project to its successful conclusion would be available. The researcher's confidence of achieving adequate feedback from participants was based on the satisfactory response rates generally achieved by Maltese students in their dissertations whilst reading for the accountancy degree at the University of Malta. As explained later on in this Chapter, the Department of Accountancy at the University of Malta has strong links with the relatively small auditing profession and the business community in Malta. Accordingly, access to audit practitioners, technical partners in audit firms, as well as owner-managers / directors / shareholders of companies was identified as being readily available in Malta. Studying the identified research gap in a small country like Malta was therefore considered as providing an excellent "laboratory" for analysing the perceptions of auditors and shareholders on the financial statements expectations gap.

3.3 SOCIAL, POLITICAL AND ECONOMIC ENVIRONMENT

Throughout history, Malta's location in the middle of the Mediterranean Sea has provided it with a significant strategic importance. Malta has always been at the cross-roads of the trading and warring routes of the Mediterranean Sea. A succession of powers including the Phoenicians, Romans, Arabs, Normans, Aragonese, Knights of St John, French and the British ruled the islands over the years. Malta was also a former colony of the United Kingdom. It gained its independence from the United Kingdom in 1964. It then became a Republic in 1974, whilst retaining membership in the Commonwealth of Nations. Malta was admitted to the United Nations in 1964 and to the European Union in 2004.

The social environment of Malta is generally a conservative one, and the absolute majority of the population is Roman Catholic. However, over the last decades, the

Maltese society has consistently changed and evolved, becoming more open and similar to contemporary European societies.

Malta has no natural resources. Furthermore, with a small population, the domestic market for produce is relatively insignificant. Owing to its strategic location, Malta used to thrive on international trade. The manufacture of commodities for export was one of the main contributors to Malta's economy up to a few decades ago. The focus of the Maltese governments over the years was to encourage foreign direct investment in high value added and export oriented industries. In more recent years, tourism and the provision of financial services have witnessed an exponential growth.

Malta has a dynamic economy which is today very much based on international trade, tourism, financial services and the gaming industry. Amongst its achievements over the last few decades, Malta has built a sound and competitive manufacturing and services base that does not rely only on its favourable geographic position, but also on its multi-skilled and multi-lingual workforce. The country offers political stability, healthy industrial relations, a pleasant and secure living environment and evident cost advantages together with high productivity levels. It also has a good infrastructural set-up with advanced telecommunications systems. Malta has an excellent air and maritime distribution network which is particularly important given the fact that Malta is an island.

The smallness factor, however, does pose a number of challenges for Maltese businesses. The domestic market is a small one, generally dominated a few entities that engage in severe competition between themselves (Ernst and Young, 2013). Given the size constrains, there is very limited opportunity to take advantage of economies of scale as would generally happen in larger countries. Financing options are also limited – although having a Maltese capital market, this market is also likewise constrained. There are no venture capital structures and investment banks consider the local economy too small to provide a local service (Ernst and Young, 2013). Private companies are therefore generally financed through a combination of shareholder funds and bank finance.

Malta and the UK have long had a close relationship, and they share a number of common ties, including historical milestones, language, business contacts, international relations and tourist influxes. These close links also extend to accounting and auditing practices. In fact, for many years, UK regulation has had a significant influence on Malta's accounting and auditing practices. However, in the last decades, and particularly following Malta's accession to the EU and the adoption of the Euro as its currency, Malta has sought to establish itself as a hub of financial services in the Mediterranean region. Financial services legislation has been enacted with the objective of supporting Malta's evolving role within the international sphere. As a result of this evolving role in financial services, departures have steadily been occurring from a UK-based regulatory framework to one increasingly influenced both by international standards and European Union requirements. One such departure, for example, relates to the retention of the statutory audit requirement for all Maltese companies, despite its earlier abolishment for small companies in the UK.

The number of Maltese registered companies exceeds eighty one thousand as of June 2017, yet only about half of them may be considered to be active companies. A predominant characteristic in the corporate governance structure of these companies is that the directors are also the ultimate beneficial owners of the company. Ownership and control are typically vested in the same person or group of persons and consequently these companies are often referred to as "owner-managed companies" (De Gabriele, 2001; Doublet, 1999; Mangion, 2001; Tabone and Baldacchino, 2003). Companies with a high level of family ownership are usually characterised by business being based more on informal relationships than on formal legal contracting. Board decisions may be taken by family members in informal settings and outside the boardroom formalities that would normally apply in a non-family run entity. Family members have their own private network and communicate with other shareholders within the same family. This environment has been identified as reducing the demand for public disclosure (Ball *et al*, 2000). In such a situation, any minority outside investors or family members not involved in the day-to-day operation of the business will, on the other hand, be disadvantaged because they may be kept uninformed and may have to rely solely on the public statutory disclosures.

The existence of a heavily concentrated ownership in Malta may lead to different reporting practices than those existing in other jurisdictions where ownership and control are more widely dispersed. For example, companies with a high ownership concentration may be unwilling to provide voluntary disclosures. This is because the majority of shareholders may have alternative ways of obtaining information (such as through their direct involvement in the day-to-day running of the business). Consequently, the level of voluntary disclosure in Malta may not be as high as in other developed countries, with disclosure to outside third parties generally being limited to the bare minimum disclosures required by statute in the case of private companies.

Owner-control was also identified as being predominant in Maltese listed public companies, with major shareholding blocks dominating boardrooms and management. Baldacchino *et al* (2013) conducted a study on board/management relationships in Maltese listed entities and concluded that the companies investigated experienced the hallmarks of a small island economy, with their governance exacerbated by the reluctance or inability of shareholders to exercise their voting rights and powers of control. The empirical findings of this study were based on an inspection of the annual reports of all twenty companies listed on the Malta Stock Exchange as at 31 December 2010. The limited number of companies listed on the Maltese stock exchange is already an indication of the smallness associated with the local stock market. Within such an environment, major or substantial shareholders were found to dominate most board and management teams. In fact, out of the twenty companies investigated, nine (45%) had major shareholders with an excess of a 50% interest, and six other companies (30%) had smaller substantial shareholders owning between 30% and 50% of the company's share capital. Out of a total number of 146 board directors, 49 (33.5%) were directly appointed by significant shareholders. Notably also, while the other directors were elected at the Annual General Meeting, only 23 of them (15.8%) were found to be non-executive directors. One also needs to keep in mind the commonly known inertia of small shareholders in participating in Annual General Meetings, thus resulting in many shareholders not exercising their voting rights. It is therefore evident that owner-control is a feature that characterizes both private and public companies in Malta.

3.4 THE DEVELOPMENT OF ACCOUNTANCY IN MALTA

In Malta, the development of the accountancy and audit profession was influenced by developments in other countries, mainly the UK. In the very early stages, and prior to the introduction of the Maltese Income Tax Act in 1948, the accountant was often referred to as "*l-iskrivani*" (the Maltese equivalent for "book-keeper"). The notion of accountancy as a profession had still not made an inroad and accounting was mainly related to keeping proper books of account using the double-entry system. The role of the accountant started taking a new and more challenging dimension as a result of the introduction of the Income Tax Act and the post World War II wave of industrialization in Malta.

The Malta Institute of Accountants was founded in 1942. Initially, it primarily consisted of experienced bookkeepers holding key positions in the Maltese civil service. It also included members employed with Turquand Youngs and Co. This was, at the time, the only foreign auditing firm in Malta. Over the years, businesses expanded and international trade increased. With the expansion of business and a growing economy, the importance of the accountancy profession, as distinct from that of book-keepers, was more generally felt. This development resulted in the birth of another local body of accountants, named "The Malta Corporation of Accountants". This was incorporated in 1954. The Corporation stemmed from a group of qualified individuals whose ambition was to see a truly local accountancy profession emerging in Malta. A requirement for membership to the Corporation was the possession of a recognised accountancy qualification. Alternatively, the applicant needed to show that he was in the process of reading for such qualification.

There were many years of intense competition between the two institutions. This is because both institutions were essentially competing for the same resources, and given Malta's limited human resources, there was only a small pool of individuals available. This competition was increasingly intense because of the smallness of the island and consequently the limited human resources that were available. The enactment of the Commercial Partnerships Ordinance was a major milestone for the profession. It provided for the requirement of limited liability companies to appoint an auditor. This was in fact the first statutory recognition of the profession in Malta. The Commercial

Partnerships Ordinance stated that the Minister (of Finance) could only grant a warrant to act as auditor to members of a professional accountancy body. This meant that the law needed to recognise a “chamber” of accountants and auditors. Both existing bodies at the time wanted to achieve this recognition. Eventually, a merger was proposed between the Malta Institute of Accountants and the Malta Corporation of Accountants, and a new merged body was set up on 28 May 1965 under the name of the “Malta Institute of Accountants”, thereby creating Malta’s unified professional body of accountants.

In view of the ever-increasing demand, in 1967, the Institute introduced its professional examinations. An educational path was therefore established for Maltese wishing to pursue a career in accountancy. The educational component of the examinations was very much based on that set by UK accountancy bodies, particularly in view of the good relationships that the local Institute had with them. The examinations, spanned over a five-section curriculum, and included specific papers relating to Maltese legislation, such as law and income tax. This step was critical in the promulgation of the profession locally. This is because before the introduction of the Institute’s examination scheme, the only opportunity one had to qualify as an accountant was to study abroad, at a significant cost to the person wishing to pursue this route. The setting up of a local examination scheme gave Maltese prospective students access to local tuition and to a local path leading to an accountancy qualification. This educational route was further enhanced in 2003, when based on the Institute’s relationship with ACCA, the ACCA-MIA Joint Examination Scheme was established through which students could obtain both an ACCA and, subject to them sitting for the local variant papers, an MIA qualification.

In 1977, the Malta Institute of Accountants became a founder member of the International Federation of Accountants and the International Accounting Standards Committee. This membership resulted in the local Institute achieving a formal recognition of the status of the local profession. In subsequent years, it also brought about the adoption of International Accounting Standards and Auditing Guidelines, today International Financial Reporting Standards and International Standards on Auditing, by members of the local profession. The formal legal recognition of accountancy as a profession in Malta

came about in 1979 with the enactment of the Accountancy Profession Act. This Act introduced the granting of a warrant of Certified Public Accountant by the Minister of Finance.

The University of Malta also played a very significant role in the development of the accounting profession in Malta and is today widely recognised in Malta as the main educational path for Maltese accountants and auditors. The University route provides a strong nexus between instruction and practical insights, with an appropriate balance of theory and practice in the curriculum. The University has also strong ties with accounting and audit firms that help to provide a linkage with research findings in a small country such as Malta. The Department of Accountancy at the Faculty of Economics, Management and Accountancy has a library that includes more than twenty years' worth of accountancy related dissertations. This collection is rich and varied. It covers various aspects of the accountancy profession, with a particular emphasis to Malta.

In the present course of Malta's economic development, the reliability of accounting information is crucial. In this regard, the audit function attests the welfare of a broad range of societal parties. This explains why the role of the accountant and auditor in Malta has grown in its relative importance and perception by society at large, reaching levels that are comparable with other traditionally highly respected professions in Malta such as lawyers and doctors. Indeed, the development of accountancy and audit in Malta has been such that the profession has now become a meaningful contributor to every sector and aspect of the economy. The profession's local importance will carry through to the future provided that it remains relevant to the business world and to the public interest, as well as provided due importance is given to effectively educating tomorrow's accountant.

3.5 THE ACCOUNTING FRAMEWORK

The early financial reporting regulatory framework in Malta consisted of the Commercial Partnerships Ordinance 1965 which was mainly based on the UK Companies Act 1948 with respect to the provisions relating to limited liability companies. The Companies Act

(Chapter 386, Laws of Malta) was then enacted in 1995. This legislation was an important milestone of financial reporting in Malta. To a large extent, the Companies Act was based on the UK Companies Act 1985, as amended in 1989.

The Companies Act requires every Maltese limited liability company to maintain proper accounting and other records that will sufficiently explain the financial performance and financial position of the company, and which will enable the preparation of a true and fair set of financial statements. The responsibility for the preparation of financial statements is vested in the directors of the company, who are required to prepare financial statements in accordance with generally accepted accounting principles and practice (GAAP).

The Maltese Companies Act originally required adherence to IFRS for all companies. Differential reporting was subsequently introduced in Malta through the IAS Regulation requiring adherence to IFRS as adopted by the EU for the consolidated financial statements of listed entities. As from October 2008, the default GAAP in Malta changed from “IFRS” to “IFRS as adopted by the EU” in terms of the requirements of the Accountancy Profession (Accounting and Auditing Standards) Regulations 2009 published in terms of the Accountancy Profession Act. These regulations also included a proviso that compliance with GAAP may be achieved by adherence to general accounting principles for qualifying private or small and medium sized companies as may be further prescribed by any regulations, directives and/or guidelines issued from time to time. It is within the context of this proviso that the development of an accounting framework for small entities in Malta had been embarked upon in 2006.

Over the past decade, business and capital markets became increasingly challenging, with greater complexity in business models, sources of risk, uncertainty and a greater emphasis on how risk is managed. Financial reporting standards had to keep up with these changes, perhaps most notably with the more widespread use of fair value accounting (which often demands complex judgmental measures) and with the inclusion of extensive disclosures in financial statements. Malta, having introduced the mandatory use of IFRS for all companies ever since 1995, was not immune to these developments. Over the years, this requirement was considered as becoming increasingly onerous for local small entities,

and hence in 2009, the Companies Act was amended to permit small companies to adopt General Accounting Principles for Smaller Entities (GAPSE), a special accounting standard developed under the initiative of the MIA. GAPSE allowed a historical cost option for all assets and liabilities, but it allowed alternative measurement bases in particular circumstances. It also contained significantly reduced disclosure requirements when compared to IFRS.

GAPSE was developed at a time when the IASB was itself developing its own accounting framework for small entities. The staff draft of the IFRS for small and medium-sized entities (“IFRS for SMEs”) released by the IASB in September 2006 was considered as still being excessively complex when compared to the needs of local SMEs (Flynn, 2008). McHarg (2010) remarked that the preparation of the draft standard did not even include a survey among SMEs, users or preparers, and neither was it based on field tests. A locally drafted set of accounting principles was therefore, at that time, considered as offering a simpler and more effective solution to relieve small non-public interest entities in Malta from the burdensome requirements of IFRS.

In July 2009, the IASB published its completed and revised IFRS for SMEs. The final published version of this standard proved to be a considerable improvement over the staff draft (McHarg, 2010). It unexpectedly turned out to be a more simplified and abridged version of the full standard. Notwithstanding this development, the Maltese GAPSE remained the allowed alternative for local companies on the basis that it was a robust set of accounting principles that made financial statements shorter, but still comprehensive, more user-friendly and more relevant to the local users.

A further change to the Maltese accounting framework was implemented in August 2015 when the General Accounting Principles for Small and Medium-sized Entities (GAPSME) Legal Notice was published. This new accounting framework replaced the former GAPSE which needed to be updated to reflect the requirements of EC Directive 2013/34/EU. This Directive brought about a new set of financial reporting requirements for both separate and consolidated financial statements for financial reporting periods commencing on or after 1 January 2016. The over-riding objective of this new accounting

framework was to simplify the financial reporting obligations for small and medium sized companies. This was in turn expected to increase harmonisation across member states, leading to greater comparability of financial statements. Thus, for example, under GAPSME, a complete set of financial statements for a small entity will comprise a balance sheet, an income statement and selected notes to the financial statements. A medium sized entity will additionally be required to prepare a statement of changes in equity and a statement of cash flows. GAPSME applies only to those entities which satisfy two out of the three eligibility criteria shown in Table 3.1 below. It cannot be adopted by large and public interest entities since these are required to prepare their financial statements in accordance with IFRS as adopted by the EU.

	GAPSME		GAPSE
	Small	Medium	
Balance Sheet Total	<= €4 million	<= €20 million	<= €17.5 million
Total Revenue	<= €8 million	<= €40 million	<= €35 million
Average Number of Employees	<= 50	<= 250	<= 250
	2 out 3 criteria		All criteria to be satisfied

Table 3.1 GAPSME – its applicability

The measurement and recognition principles in GAPSME are not very different to those previously applicable under GAPSE. Indeed, in the most part, the requirements of the Directive are limited to presentation and disclosure, such that the fundamental recognition and measurement principles previously set out in GAPSE were, in the large part, still applicable.

3.6 THE AUDITING FRAMEWORK

The duties and powers of the auditor are also set out in the Companies Act. The auditor's responsibility is to conduct a statutory audit in accordance with ISA in order to be in a position to express an independent opinion on whether the financial statements prepared

by the directors give a true and fair view of the company's financial position as at the end of the reporting period, its financial performance and cash flows for the period then ended in accordance with the requirements of the applicable financial reporting framework.

The audit market in Malta is composed of the Big Four audit firms, small and medium sized practices and a number of sole practitioners. Up to the 1980s, most of these firms were mainly engaged in traditional accounting and statutory audit services, with specialized services such as tax being undertaken on a limited scale. The economic boom of the 1990s and the arrival of international trading companies enabled these firms to flourish. A number of multi-national entities, including financial services companies, established in Malta and this demanded more sophisticated accounting and business services. In addition to the boom in the international business, the local companies expanded too. Given the adoption of IFRSs in Malta as an accounting framework, accountancy graduates working with the Big Four audit firms benefitted from experience working abroad on international audit assignments. These firms encouraged local graduates to assist foreign audit teams in the performance of audit work, and this helped to widen the knowledge-base and experience gained by Maltese graduates. To a certain extent, one may say that these international audit firms have also played a key role and helped to shape the accountancy profession in Malta.

At present, the Maltese Companies Act imposes a statutory audit requirement for the financial statements of all companies, irrespective of their size, capital structure or business activity. The only exception is in respect of certain audit exemptions granted to micro companies that do not exceed two of the following three criteria: balance sheet total: €46,587.47; turnover: €93,174.94; average number of employees: two (Section 185 (1b) of the Companies Act, 1995). The objective of introducing this exemption at the time was to reduce compliance costs for micro companies and therefore improve their competitiveness. However, in practice, it is questionable whether such an objective has been achieved considering that the Maltese income tax legislation still demands the preparation and submission of audited information. This exemption was therefore somewhat of a superfluous one.

The Maltese mainstream company profile is characterised by ownership and management being vested in one person or the same group of persons. Where the ultimate beneficial owners are also the directors of a company, a statutory audit could seem superfluous as far as its main purpose - shareholder protection - is concerned. This is because shareholders, through their daily involvement in the running of the company, have a detailed knowledge of the business' affairs and are therefore in a position to know the true financial state of affairs of the company as a consequence of the decisions taken in their capacity as directors (Tabone and Baldacchino, 2003).

Nonetheless, despite this factor, empirical research indicates that for Maltese owner-managed companies, the statutory audit still fulfilled two important roles: it was relevant to outside third parties who had no direct ownership interest in the company but who nonetheless contributed to the viability of the enterprise, and it had a positive effect on the owner-manager and staff (Tabone and Baldacchino, 2003). This positive effect was the result of a number of factors – the audit process imposed financial discipline on the owner-managed company, it had a deterrent psychological effect against errors and other irregularities, and it also granted the owner-manager access to financial expertise. The MIA shared these views, and in fact, in its comments on the proposals set forth in the Green Paper, the MIA commented that the various users of general purpose financial statements, who had no other means or access to financial information, drew significant benefit from high quality audited financial statements (MIA, 2010a). Having all companies, including SMEs, audited contributed significantly in promoting fiscal propriety, adherence to rules and regulations (including anti money laundering legislation), and more rigour in the recording of business transactions.

Naturally, the statutory audit requirement in Malta also applies to public interest entities such as listed companies. In recent years, with the advent of the Malta Stock Exchange in the 1990s, the number of companies listing their equity instruments and/or debt instruments has increased significantly. Indeed, after the year 2000, the birth of a share and debt ownership culture Malta was witnessed in Malta (Cassar, 2007). The number of Malta Stock Exchange individual accounts amounted to 73,500 in 2016 (Malta Stock Exchange, 2016). This is a relatively high amount, especially considering the limited

number of companies that are listed on the Malta Stock Exchange and also keeping in mind the fact that Malta is a small country with a relatively small population. This scenario contrasts with other foreign countries, such as the United Kingdom and the United States, where the majority of shareholders are institutional investors. Maltese consumers are today also affected by the service auditors provide not only as possible present or potential investors of local listed entities, but also in other capacities, such as through being pension fund beneficiaries.

3.7 THE LOCAL CAPITAL MARKET

When compared to international markets, the Malta Stock Exchange is considered a relatively new stock market. It came into being upon the enactment of the Malta Stock Exchange Act in 1990. Trading operations commenced in January 1992. Today, the Malta Stock Exchange is a fully-fledged regulated market which fulfills the important role of providing an effective venue to raise capital for Maltese companies. It provides a structure for the admission of financial instruments to its recognised lists which may subsequently be traded on the secondary market. The main participants in the market are the issuers, stock exchange members (stockbrokers) and the investors in general. Apart from admission and trading, the Malta Stock Exchange also offers a comprehensive range of back-office services, such as the maintenance of share and bond registers, and custody services. It also has links with international stock markets to facilitate international access.

Unlike other countries where retail investors are a very small proportion of the total investors on the stock market, the Malta stock market is predominantly a retail one. This presents certain challenges as most retail investors lack financial knowledge about stock markets, unlike institutional investors who would have their own specialised technical teams. Accordingly, in recent years, the emphasis has been placed on educating investors. The Malta Financial Services Authority, together with other stakeholders, took various initiatives (such as organising short courses and developing educational webs-sites) targeted at educating investors and improving the overall knowledge for retail investors.

The number of issuers listing equity and debt instruments has steadily increased over the years. The industry in which the issuers operate is also a varied one, and includes inter alia the following industries: banking, insurance, postal services, hospitality and leisure, manufacturing, communications and the retail industry. This increase was mirrored with corresponding increases in the number of trades and in the turnover values of transactions. The Malta Stock Exchange 2016 Annual Report states that in 2016, market transactions amounted to a turnover value of just over €680 million, with the number of transactions increasing by 11% to a total of 365,662 trades in 2016. Despite the overall increasing trend in volumes, the number of issuers is still a limited one when compared to international standards. As of 31 December 2016, the number of equity issuers amounted to twenty-five and the number of corporate bond issuers stood at sixty-six.

Apart from providing access to capital, the Malta stock market *also* offers other advantages to issuers. For example, listed instrument trades are exempt from capital gains and from transfer duty. Despite these advantages, Maltese companies have not proactively sought to approach the stock market for raising capital. One of the reasons for this slow take-up is attributable to the fact that many Maltese companies are family businesses whose owner-managers are generally keen to retain control over the business and eventually pass on their business to future family generations. In Malta, family / owner-managed businesses are a mainstay of the economy. These businesses may not be large by international standards, but they generate a considerable amount of the country's wealth, and they also represent the main client base for the Maltese accountant and auditor. In providing services to such firms, the Maltese accountant and auditor will over time inevitably be faced with family issues that may impinge on the company's operations – matters such as for example, family disputes over remuneration or dividend policy, or charges of infighting or nepotism. In such circumstances, the Maltese accountant and auditor assumes an important role as a trusted business advisor, providing an independent and objective assessment that may facilitate decision making within the company and make the business better equipped to deliver stronger results in the future.

3.8 MALTA AND THE EUROPEAN UNION

As a member of the European Union, the Maltese accountancy and audit profession have a direct interest in developments within the EU institutions with respect to the developing the role of the auditor. Following the severe global economic crisis that commenced in 2008, the European Commission launched a debate on the suitability and adequacy of the statutory audit process. This debate did not impinge on the Commission's stated belief that the audit and the auditor had an essential role to play in global economies, mainly that of supporting stable capital markets and financial systems, as well as in developing SMEs. However, the magnitude and scale of the financial crisis led some to seriously question the quality of the audits performed during the period. A more skeptical back-to-basics approach, involving a greater focus on obtaining evidence to support the commercial substance of the assets and liabilities at the year end, was suggested. Auditors were criticised by regulators for a lack of professional skepticism by being too ready to accept the views of their clients on, for example, certain critical accounting assumptions, judgments and estimates.

The said economic crisis also called many aspects of the audit process and audit quality into question worldwide. Auditing is a complex discipline and over the last few decades, the audit profession has been actively engaged in debating how audit quality could be further enhanced. One of the initiatives was the launch of the ISA Clarity Project, a comprehensive program embarked upon by the IAASB in 2004 and completed in 2009, aimed at enhancing the clarity of auditing standards. This program involved the application of new drafting conventions to all ISA, either as part of a substantive revision or through a limited redrafting, to reflect the new conventions and general matters of clarity. It was expected that this project would be a milestone in enhancing the framework which drives audit quality. In fact, this project was described by David Maxwell (IFAC, 2009, p.1), Chairman of the Forum of Firms, as:

“one of the most significant projects in the history of the IAASB. Completion of this project will result in many improvements to the ISA and significantly advance global convergence of auditing standards.”

The Statutory Audit Directive was another milestone in the enhancement of audit quality. The introduction of quality assurance in Malta through the transposition of the Statutory Audit Directive contributed significantly to enhancing audit quality following the introduction of requirements notably on approval and registration of auditors, their education, ethics and independence, public oversight and investigations. Continued professional development requirements to which most European accountants, including Maltese ones, are subjected to, also contribute significantly to higher audit quality.

Notwithstanding all the above initiatives, following the recent financial crisis, the audit function was again placed firmly in the public spotlight. In the face of the major corporate collapses, initially it was the credit rating agencies that found themselves in the immediate firing line, with accusations of blame being placed centrally on them (Möllers, 2009). However, the position changed in a short span of time and government and regulators started raising questions on the contributions made by auditors and the scope of auditing at law and in auditing standards. Such debates stimulated reflections that the audit function may not be well versed to dealing with the turbulent and uncertain times of financial crisis (Power, 2010). The European Commission was similarly engaged in this debate on auditing. In a two day conference organised by the European Commission in February 2011, European Commissioner Michel Barnier (Commissioner for Internal Market and Services) stressed that:

“the status quo is no longer an option. The status quo is not an option for the auditing world. It's not about changing for the sake of change, but to reply to very real needs which we can no longer ignore” (ICAEW, 2011, p.1)

The basic role envisaged for the auditor in an EU context was seen as giving assurance that the financial statements prepared by companies in different countries were reliable and comparable such that the EU's internal market could function properly. However, according to Commissioner Barnier, the general role of auditors had not really been questioned following the crisis. Accordingly, the Green paper entitled *Audit Policy: Lessons from the Crisis* (EC, 2010) was issued in October 2010. This paper generated a lot of interest both within and outside the profession, with over six hundred responses being received by the Commissions (EC, 2011). On 30 November 2011, the European Commission adopted proposals aimed at addressing the weaknesses identified in the EU

audit market, by eliminating conflicts of interest, ensuring independence and robust supervision and by facilitating more diversity in what was described as an overly concentrated market, especially at the top-end. Such initiatives, together with other proposals to reduce the administrative burdens to support entrepreneurship and responsible business, clearly impact the Maltese accountancy profession.

3.9 ACCOUNTANCY EDUCATION IN MALTA

The solid reputation of the accountancy profession in Malta is the result of its robust educational tuition paths. The two main tuition paths in Malta are the University degree which is basically the Master of Accountancy degree (this course was upgraded to a Master level in academic year starting October 2012 replacing the former Bachelor of Accountancy (Hons) degree) and the ACCA/MIA Joint examination scheme. The University route is a five year full time course offered by the University of Malta. The course is basically split into 2 parts: the Bachelor of Commerce degree and the Master of Accountancy degree. The number of graduates attending this course has increased significantly over the last 25 years. It started off with 19 students graduating in 1983 and has since increased to an average of 100 students graduating in each academic year. The other main tuition path is the ACCA/MIA joint examination scheme. This is a relatively new route whereby ACCA and MIA have teamed up some years ago to create a joint examination scheme that local students may take up. This tuition path was also a successful one with Maltese candidates generally outperforming the global examination average pass rate. The aforementioned tuition paths have along the years provided the Maltese growing economy with the necessary expertise in accountancy and financial services.

The UK has always had a strong impact on accountancy education in Malta. Up until a few years ago, accounting syllabuses in Malta were modeled on UK examinations and UK accounting standards were referred to. Textbooks used in secondary and tertiary education were British. Company law requirements were also modelled on the requirements for the UK counter-parts. However, as already explained, over the last few decades, the Maltese regulatory environment has departed from the UK-base to one that

is increasingly influenced both by international standards and European Union requirements.

The element of accountancy education also features in the requirement for professional accountants to remain abreast of developments within the profession over the years. Being a professional entails having the required knowledge, skills and attitudes for a particular job. Since accountancy is a very dynamic field, obtaining a professional qualification, on its own, is not enough. For this reason, Maltese accountants are obliged by law to undertake Continuing Professional Education (CPE) activities to maintain and enhance the required knowledge and skills, as well as remain up to date with the regular changes occurring within the field.

3.10 INSIGHTS FROM RECENT RESEARCH IN A SMALL ISLAND STATE

A repeatedly emerging factor in recent Maltese research in accountancy and auditing has been the strength and importance attached to behavioural relations between parties in the closer-knit communities of small countries. Various behavioural / sociological aspects affecting the accountancy and auditing profession have been researched in Malta and the following sections provide an overview of some interesting research findings relating to small island state influences.

3.10.1 SMALL ISLAND STATE INFLUENCES

The main source of research literature on small island state influences in Malta takes the form of the dissertations that are submitted annually to the University of Malta by students completing the accountancy degree programme. Auditing is one of the more popular subjects targeted by students. This popularity emanates from the fact that auditing is one of the core areas covered in their studies and also by the interest and support given by audit firms, being the prospective employers of graduates, to such studies. The research studies on auditing cover a very wide range of subjects and are not limited to external auditing. Other branches of auditing such as internal auditing, public sector auditing, forensic audits, compliance audits and value for money audits have also been researched.

Some of the research findings from these studies have also been used as a basis for publication in foreign peer reviewed journals.

This section is not meant to provide a detailed overview of all the topics that have been researched and their respective findings. Instead, the researcher has sought to identify the more relevant findings on the subject of external auditing that can be used to highlight the extent of small island influences on audit practice, some of which will also be found to be relevant for this study.

Thus, for example, according to a survey by Attard (2010), every year around 1.48% of Maltese companies change their auditors and around 66% of companies changed their auditors at least once since incorporation. In a published study by Magri and Baldacchino (2004) on the factors that contributed to client companies carrying out such a change, it became evident that, unlike larger countries, Maltese client companies gave top priority to retaining relationship bonds with their auditors over other economic considerations (such as audit fees) or technical competence. Indeed, in Malta, good relationships with the auditor are considered much more crucial than elsewhere and than anything else, even cheaper audit fees. This finding was re-inforced in a study by Baldacchino and Cardona (2011) on factors influencing first-time auditor selection in Maltese companies. In this case, behavioural factors, such as establishing a long-term relationship with the auditor and the availability of the auditor when needed, again took precedence over economic ones (audit fees). In relation to audit fees, Attard (2010) investigated the main factors influencing the external audit fees in Malta, including ascertaining whether client size, complexity and risk (these being the “traditional” determinants of audit fee levels) are applicable. Results indicated that the amount of external fees was significantly influenced by audit client size, complexity, risk, ownership control and corporate status. Additionally, a fee premium was found to accrue to the Big Four audit firms in Malta. This research also provided evidence that there existed two significant market-specific factors affecting audit fee levels, namely whether the company was government-owned and/or owned by foreign shareholders. The former experienced higher than average fees while the latter benefitted from lower ones.

Another interesting behavioural aspect that has emerged as a distinguishing factor in Maltese research studies is the confidentiality paradox. Malta as a tiny island-state is heavily characterised by close interweaving personal relationships, making it more difficult, even for professionals, to maintain confidentiality than in larger countries (Magri and Baldacchino, 2004). Many Maltese clients seem to go to great pains to keep information officially secret. The paradox is explained by the fact that while the informal information system is fully informed, the formal reporting system remains unfed and unresponsive (Baldacchino, 1992a). This paradox or apparent contradiction affects the practice of accountancy in various ways. For example, the introduction of formal internal whistle-blowing is spoken of very favourably; however, in fact, it is still very much resisted in many public limited companies, with only very few (often with foreign connections) having formal procedures in place. In a survey on Maltese public limited companies, Gauci (2006) identified that as much as 11% never thought of introducing internal whistleblowing and 28% have an “intention” to introduce internal whistleblowing. It was only 17% that in fact already had such policies in place. Furthermore, local auditors are not yet empowered in statutory audits to override, whenever they consider fit, their duty of confidentiality for the reporting of management fraud to outside third parties (such as the regulator) even though ISA 250 allows this after taking appropriate legal advice on whether they have a clear duty to disclose. Baldacchino (1992b, p.182) reported that two surveyed accounting professionals emphasized that in a small place like Malta:

“people often know much more than they dare inform the authorities. If auditors are required to blow the whistle, management will start keeping them in the dark”

and that:

“in our small community, the mentality is that if you roll over stones in the end you will hurt your toes. So most auditors will prefer the authorities to find any irregularities for themselves.”

Gate-keeping is another sociological phenomenon that regulates access to information in the Maltese environment. It is considered to be more common in smaller countries since there are, fewer, if any, alternative pathways to “pass through” once a gate is found “closed”. This issue can be further compounded by hat-changing, a situation where the same person or group of persons assumes various different, sometimes even conflicting,

roles. These two phenomena clearly have implications on accountancy practices – conflicts of interest, independence and corporate governance in general. In fact, smallness does not necessarily have to lead either to restrictive gate-keeping or even less to automatic hat-changing or role multiplicity. In practice, hat-changing in small countries such as Malta, in particular, is often rationalised (or wrongly reasoned out) by the perpetrators and accepted on the basis that there are not enough specialists around. The result is often tolerating a multiplicity of roles, which too often may be incompatible. With both gatekeepers and hat-changers, whether systems work or not depends unduly, if not blindly, on trust: this is because there is often no-one guarding the guardian (Baldacchino, 2011).

A relatively higher audit qualification rate was also identified in Maltese audit reporting, mainly because of the statutory requirement, referred to earlier, practically to have all companies audited irrespective of their size. A survey by Farrugia and Baldacchino (2005) showed that in fact Maltese companies had a particularly high rate of qualifications (19.9%) with the highest rates of qualification being those for small, private exempt companies. It was also found in this study that limitation of scope qualifications were most likely with smaller companies and they were more prone to be issued by non-Big Four firms, while disagreement-with-management qualifications were more prevalent in larger companies and were issued mostly by the Big Four audit firms. A subsequent update of this study in 2014 by Baldacchino *et al* (2014) identified a slight increase in the average qualification rate in Malta to 22.4% between 2005 and 2009, with many of the shortcomings of audit reporting identified in previous studies still being prevalent, particularly for the smaller audit firms and sole practitioners.

The high ownership concentration in Maltese companies was also found to affect the users' perceptions about the relevance and usefulness of the financial statements, and hence to impact on the timeliness with which financial statements are finalised. A study by Baldacchino *et al* (2015) identified that Maltese private companies have an average audit report lag (the period of time that elapses between the financial year-end and the date of the auditor's report) of 223 days. This means that, on average, Maltese private

companies take approximately more than seven months beyond their balance sheet date to have their financial statements finalised and made available to the shareholders.

3.10.2 THE AUDIT EXPECTATIONS GAP – THE LOCAL EXPERIENCE

On a Maltese level, research studies on the expectations gap have been conducted at undergraduate level within the Department of Accountancy at the University of Malta. These studies have shown that an audit expectations gap has existed within the local context for many years (Scerri, 1987; Muscat 1992; Mizzi, 2002; Desira and Baldacchino, 2005).

Mizzi (2002) conducted a study on investors' perceptions on the statutory audit of Maltese listed companies, wherein it was established that around two-thirds of private investors believed that an audit is a "guarantee" that the financial statements were accurate. This is in line with the findings previously reported in earlier local studies (Scerri, 1987; Muscat, 1992). Another misconception identified by Muscat (1992) was that around half of private investors and one-third of the public believed that auditors tested all the client's transactions. This misconception was re-confirmed by Mizzi (2002) and Desira and Baldacchino (2005) about ten years later, thereby providing further evidence that the expectations gap still existed within the local scenario.

Desira and Baldacchino (2005) noted that members of the public and auditors had a number of divergences on the perceived role of the external auditor. In particular, according to this study, the Maltese public perceived the auditor as being responsible for the maintenance of a client's accounting records, the prevention and detection of fraud, and the appropriateness of a client's internal control system, as well as providing assurance that the financial statements contained no material misstatement. Moreover, this study provided empirical evidence that the Maltese public was uncertain whether the auditor made use of sampling during the audit, and whether it was the auditor or the client who actually selected the audit procedures to be performed.

Scicluna (2010) opined that a fair share of the expectation gap manifested itself locally in the form of the increased trend for government bodies/agencies to request certifications of private sector financial information in tendering procedures and/or European Union funding programmes. For example, in certain tendering procedures, Maltese tenderers were requested to submit past historic audited financial statements, but also future projected financial information which was required to be effectively certified as “correct” by an audit practitioner. Whilst the motivation behind such requests indicated an underlying favourable recognition being given to the local accountancy and auditing profession, the end result was “somewhat of a good idea gone awfully wrong” (Scicluna, 2010, p.4). Following appropriate discussions with the relevant authorities, technical releases were published by the MIA to provide guidance on engagements to report on financial data required for tendering processes and for reporting on entity size declarations for the purpose of obtaining finance under certain European Union assistance schemes.

The MIA opined that users of financial statements should be educated on what is implied by “reasonable assurance” since “the expectations gap surrounding the statutory audit is in the main attributable to this fact” (MIA, 2010b, p.4) and to the fact that users of financial statements “take the audit report as a certificate or guarantee” (MIA, 2010b, p.4). The misconception on the audit report providing a “guarantee” had already been identified by Mizzi (2002) whose research findings indicated an expectation that the auditor should detect not only material misstatements but any kind of misstatement or fraud.

The role of education in bridging the expectations gap was also researched locally. By means of an empirical survey, Cassar (2007) reported that 73.5% of the Maltese respondents admitted that the decision to buy or sell shares in local quoted companies was taken on their own initiative, without taking any form of professional advice. A further cross examination of these investors proved that such investors did not understand the message conveyed by financial statements. Other respondents in this same research study claimed, rather surprisingly, that “they understood financial statements but did not find them relevant” Cassar (2007, p.67). Yet again, their scores revealed that their level

of understanding was somewhat poor. The researcher in this study also concluded, based on the empirical data collected, that “it is quite evident ... that shareholders do not read financial statements as they find them too complex and difficult to understand” Cassar (2007, p.68). It is therefore understandable that the researcher used the term “alarming” when reflecting on the fact that many local investors take investment decisions on their own initiative, without proper consultation. This is particularly more concerning when one considers the limited number of investors trading shares on the local stock exchange, as well as the fact that since 2007 (being the year when the study was conducted), IFRS disclosure requirements have increasingly become even more complex and financial statements have consequently become more voluminous.

Cutajar (2009) investigated whether the audit expectations gap in Malta could be bridged through an expansion of the auditor’s report and/or through further educating shareholders at annual general meetings. The study revealed that the Maltese public was generally supportive of such measures, while on the other hand, auditors had serious reservations on their practical effectiveness of such initiatives.

The findings of Maniscalco (2012) pose certain challenges for the profession in Malta. Maltese shareholders seemed to be in constant search of more information and assurances; they seek more information – at the same time, Maltese investors do not even utilise the existing information. This has re-affirmed the finding of Anastasi (2008) that Maltese shareholders do not bother to read most parts of the annual reports. The majority of shareholders demanded more information and assurances from the auditor, clearly indicating that they place more reliance on audited information when compared to unaudited information. However, Maniscalco (2012) found that Maltese auditors were skeptical on more information and assurances being provided, arguing that the users already have enough information available for decision-making based on the disclosure requirements of existing accounting standards.

As explained earlier on, most of the studies both on a local and international level, have focused on the audit expectations gap. Extant literature shows that only a few studies have directly examined or even considered the existence of a wider gap relating to

financial statements themselves. Such literature is practically non-existent for small states. This thesis therefore seeks to address this research gap by providing empirical evidence on the financial statements expectations gap in a small state economy, namely Malta.

Taking into consideration the above opportunity for research, particularly within a small island context (Malta), this thesis addresses the following research questions:

Research Question 1 (RQ1): *To what extent does a wider expectations gap (i.e. wider than the “audit expectations gap”) exist in Malta in relation to financial statements?*

Research Question 2 (RQ2): *Are external auditors and shareholders in agreement about the objective and the main use of financial statements in Malta?*

Research Question 3 (RQ3): *Are financial statements being interpreted as being capable of predicting an entity’s future cash flows?*

Research Question 4 (RQ4): *To what extent do respondents consider financial statements as being reflective of the performance (past and future) of the reporting entity?*

Research Question 5 (RQ5): *Are the limitations of financial statements communicated well-enough?*

Research Question 6 (RQ6): *Do certain characteristics (e.g. behavioural aspects) of a European small island state such as Malta intrinsically influence the perceptions on the message being conveyed by financial statements?*

Providing answers to the above questions informs the objectives of this study (set out in Section 1.3), thereby resulting in a contribution to the relevant literature (Section 7.9).

3.11 CONCLUSION

This chapter has explained the research setting within which the study's findings are to be interpreted and understood. It has provided an overview of the Maltese geographical, political and economical background, as well as the applicable accounting and auditing frameworks. It has also highlighted insights on small island influences that have been researched locally, including studies on the audit expectations gap. This chapter has shown that Maltese accounting and audit practices have matured and evolved over the years, and research studies conducted locally have accordingly sought to empirically uncover reasons for behaviours, attitudes and motivations. However, no research has to date been carried in Malta on the financial statements expectations gap and in this respect, this thesis has attempted to fill the research gap in this area.

CHAPTER FOUR – RESEARCH METHODOLOGY

4.1 INTRODUCTION

This chapter explains the methodological foundations of the study and evaluates the methods and strategies used to address the research questions identified in Chapter One. The research objectives of the thesis set out in Section 1.3 guide the thesis and are the key determinants of the methodological position, research design, research methods and analysis used in this study. This chapter presents an explanation of the research approach, research design and research methods adopted in this study. The structure of this chapter is as follows: Section 4.2 provides an overview of the research paradigm adopted for the purpose of this study by examining the ontological, epistemological and methodological assumptions of some alternative philosophical paradigms. Section 4.3 compares and contrasts quantitative and qualitative research, while Section 4.4 provides a rationale for the adopted mixed methods research. Section 4.5 introduces the research strategy and methods adopted for the purpose of the study. Finally, Section 4.6 focuses on the ethical considerations of the study.

4.2 THE RESEARCH PARADIGM

“The way we think the world is (ontology) influences: what we think can be known about it (epistemology); how we think it can be investigated (methodology and research techniques); the kinds of theories we think can be constructed about it; and the political and policy stances we are prepared to take.” (Fleetwood, 2005, p. 197)

There are a number of different methodological approaches to social scientific inquiry that can inform and guide research. These approaches are often contrasting ones, with differences extending to the philosophical assumptions about the nature of reality (ontology), knowledge (epistemology), values (axiology), research strategies (methodology) and procedures (methods). These philosophical assumptions influence the researcher’s choice of the research framework, either in a direct or indirect manner. It is therefore important for any research study to explicitly state and justify its

philosophical stances. Thinking through the philosophical issues is useful not only to clarify the research design but also to facilitate the identification of the most suitable approach to deal with the research questions (Easterby-Smith *et al*, 2002). An examination of ontology, epistemology and methodology is therefore important for any discussion about the nature of social science research as these elements give shape and definition to the conduct of an inquiry (Popkewitz, Tabachnick and Zeichmer, 1979).

The philosophical assumptions underpinning the choice of research design can be summarised as follows:

Ontology	What is the nature of reality?
Epistemology	What constitutes acceptable knowledge?
Methodology	What is the strategy of inquiry?
Methods	What are the procedures for data collection and analysis?

Table 4.1 – Philosophical assumptions underpinning a research design

Ontology is the foundation of research design. Blaikie (2007) defined ontology as the science or study of being. According to Hay (2002, p.63), an individual's ontological position is based on the answer to the following question: "What is the nature of the social and political reality to be investigated?" The ontological philosophy of the researcher therefore portrays the researcher's views on the nature of reality. Epistemology is concerned with understanding the nature of knowledge, its scope and the manner in which it is acquired. Epistemology therefore considers views about the most appropriate ways of enquiring into the nature of the world (Easterby-Smith *et al*, 2008). Blaikie (2000) described epistemology as the nature of knowledge about reality, arguing that there is potential to deepen knowledge about reality, if this is assumed to exist. One of the main purposes of social research is to acquire knowledge on what is actually going on and what is happening (or has already happened) in the "real world" (Bryman, 1989). Therefore,

epistemology considers the research methods since it defines how knowledge can be produced and argued for (Eriksson and Kovalainen, 2008).

The ontological and epistemological discussions lead to the subject of research paradigms. Denzin and Lincoln (2003) describe the research paradigm as an “interpretative framework”. Tashakkori and Teddlie (1998) identify four research paradigms, namely positivism, post-positivism, interpretivism and pragmatism.

Positivism assumes that “an objective truth exists in the world” (Cassell and Symon, 1994, p.2). Positivists believe that the social world exists externally and that its properties should be measured through objective measures. The positivist tradition presumes that knowledge reflects reality and that accurate knowledge exactly reflects the world as it is. According to Neuman (2003), positivist research involves precise empirical observations of individual behaviour in order to discover probabilistic causal laws that can be used to predict general patterns of human activity. For positivists, the nature of social reality is based on the premise that empirical facts exist apart from personal ideas or thoughts, and that they are governed by laws of cause and effect. Patterns of social reality are stable and knowledge of them is additive (Crotty, 1998; Neuman, 2003). A basic assumption of this paradigm, as Ulin *et al* (2004) remarked, is that the goal of science is to develop the most objective methods possible to get the closest approximation of reality. Positivist researchers explain in quantitative terms how variables interact, how these variables affect events and ultimately how these same variables result in outcomes. Explanations are often developed and tested. Techniques such as multivariate analysis for statistical prediction are typical contributions within this approach to conducting research. In summary, positivist research views reality as objective and stable where the researcher is removed from the object or phenomenon under study (Guba and Lincoln, 1994) and where truth is achieved through the verification and replication of observable findings (Guba and Lincoln, 1994).

Post-positivism is a modified version of positivism (Guba and Lincoln, 1994). Ontologically, post-positivists believe that an objective truth exists. However, post-positivists accept the fact that not all objective truth can be verified through direct

observation and the analysis of raw data. Denzin and Lincoln (1994, p.15) argue that “only partially objective accounts of the world can be produced because all methods are flawed”. Tashakkori and Teddlie (1998) consider that the objective truth cannot be ascertained with absolute certainty due to the inherent limitations of the researcher. Post-positivists believe that the background knowledge and values of the researcher can influence the research inquiry process (Denzin and Lincoln, 2005). Post-positivists accept that theories, background, knowledge and values of the researcher can influence what is observed. Furthermore, post-positivists believe that a reality exists, like positivists do, but they hold that it can be known only imperfectly and probabilistically (Colin, 2002). In terms of methodology, post-positivists frequently use multiple methods in the research inquiry.

Interpretivism is in sharp contrast to positivism. According to interpretive researchers, meaning exists in the researcher’s interpretation of the world. The research inquiry is a subjective process. The study of social life involves skills that “are more like the skills of literary or dramatic criticism and of poetics than the skills of physical scientists” (Rom Harre, cited in Phillips, 1987, p.105). Interpretivism is based on the premise that meaning exists in one’s interpretations of the world and therefore acknowledges the importance of the researcher’s perspective and the interpretative nature of social reality. In interpretivism, social reality is viewed as being significantly socially constructed, based on a process of interpretation and re-interpretation of the intentional and meaningful behavior of people, including the researcher (Smith, 1989). As a result of these interactions, according to interpretivism, there is more than one reality; in other words, there is no single reality. Denzin and Lincoln (2003) noted that the interpretivists usually consider that there are multiple realities that could be explored. Hatch and Cunliffe (2006) asserted that all knowledge is relative to the knower, whereby researchers investigate social reality by closely looking at the respondents’ point of view. Epistemologically, interpretivists consider the researcher as part of the process of acquiring knowledge wherein the researcher is the primary research tool (rather than being a distant observer as perceived by positivists). Research inquiry on the matter under study depends on the interactions between the researcher and the participant. From a methodological point of view, interpretivists do not believe in experimental research

designs. Since reality is multifaceted and cannot be fragmented or studied in a laboratory, interpretivists argue that reality can only be studied as a unified whole within its natural context (Candy, 1991). Interpretivists advocate that it is necessary for the researcher to understand differences between humans in their role as social actors and that respondents' opinions can be highly contextual rather than generalisable (Saunders *et al*, 2009). Furthermore, building a relationship with study participants can add deeper insight into the context under study, adding richness and depth to the data (Tuli, 2010). Eriksson and Kovalainen (2008) associated the interpretivist approach with the qualitative research techniques, maintaining that this paradigm is very subjective in nature and that the emphasis is on the language *per se*. Knowledge is interpretation and knowledge provides suggestive interpretations by particular people at particular times.

Pragmatism is the fourth paradigm identified by Tashakkori and Teddlie (1998). Pragmatism is:

“a position that argues that the most important determinant of the research philosophy adopted is the research question, arguing that it is possible to work within both positivist (quantitative) and interpretivist (qualitative) positions. It applies a practical approach, integrating different perspectives to help to collect and interpret data”
(Saunders *et al*, 2009, p.598)

Pragmatism refers to a philosophical position with a history that goes back to the work of Peirce, William James and Dewey (Howe, 1988; Cherryholmes, 1992) and revived by Rorty (1999). Johnson and Onwuegbuzie (2004) identify the main features of the pragmatic approach in the context of social research, while Baert (2005) discusses the implications of pragmatism for empirical research. From the ontological perspective, pragmatists agree with the positivist and post-positivist view on the existence of an external reality (Tashakkori and Teddlie, 1998). In addition, pragmatists also agree with the interpretivists on the existence of a “social and psychological world that includes language, culture, human institutions and subjective thought” (Johnson and Onwuegbuzie, 2004, p.18). According to pragmatists, epistemologically, there is no right approach in discovering truth. As a result, the approach that results in the most desired outcome is the preferred approach. According to Marshall and Rossman (1989), researchers should use the approach which best assists in answering the research

questions. Tashakkori and Teddlie (1998) suggest that it is more appropriate for the researcher in a particular study to think of the philosophy adopted as a continuum, rather than as opposite positions. This is because “at some points, the knower and the known must be interactive while at others, one may more easily stand apart from what one is studying” (Tashakkori and Teddlie, 1998, p.26).

Burke Johnson *et al* (2007, p.125) argue that pragmatism is “a well-developed and attractive philosophy for integrating perspectives and approaches” and that pragmatism offers an epistemological justification and logic for mixing research approaches and methods. Pragmatism also helps to guide the way in which research approaches can be mixed fruitfully (Hoshmand, 2003); ultimately, the objective is to mix research approaches in a way that can offer the best opportunity for answering important research questions. Howe (1998) argued that the researcher was in a position to use both quantitative and qualitative methods because they were compatible with each other. Although there were major differences between qualitative and quantitative approaches, especially in the research design and analysis of findings, it was possible to over-emphasise these differences, at the cost of failing to realize that there were also many similarities in the two approaches (Howe, 1998). Brewer and Hunter (1989, p.74) used a similar argument when stating that pragmatism employed multiple research methods to study the “same general phenomenon probably posing different specific questions”. According to Fielding and Fielding (1986), the two methods can complement each other. Use of the two methods can therefore be advantageous (Patton, 1990). Hammersley (1992) argued that qualitative and quantitative methods often shared more common ground in practice than was generally attributed to them. By understanding the common ground that existed between the two approaches, the rigid traditional distinction and the apparent incompatibility between them can be set aside (Philips, 1998). Bryman (2006, p.118) suggested that:

“in the new climate of pragmatism, ... issues to do with the adequacy of particular methods for answering research questions are the crucial arbiter of which methodological approach should be adopted rather than a commitment to a paradigm and the philosophical doctrine on which it is supposedly based”.

Based on the above discussion, pragmatism has been selected as the research paradigm for conducting research in this project with a mixed methods approach (with a sequential explanatory design) as the most appropriate methodological position to achieve the research objectives. The pragmatic approach is no “easy” option. The researcher cannot simply do what he likes. Instead, pragmatism demands considerable thinking about the research questions, and about which methods are appropriate to answer those questions. Different views may be formed on the message of financial statements – this highlights the subjective reality of the subject of this research study in practice. The preparers of financial statements, the users of financial statements and the auditing activity per se involves interaction with the environment where it operates, such as the economic and regulatory conditions in the business environment. All these factors may potentially influence what is regarded as being the message of financial statements.

4.3 QUANTITATIVE AND QUALITATIVE METHODS – APPROACHES TO RESEARCH

Quantitative and qualitative methods are research methods which require different types of data. Denzin and Lincoln (2008, p.14) explained the difference between qualitative and quantitative research as follows:

“The word qualitative implies an emphasis on the qualities of the entities and on processes and meaning that are not experimentally examined or measured (if measured at all) in terms of quantity, amount, intensity, or frequency.

Qualitative researchers stress the socially constructed nature of reality, the intimate relationship between the researcher and what is studied, and the situational constraints that shape inquiry. Such researchers emphasize the value-laden nature of inquiry. They seek answers to questions that stress how social experience is created and given meaning.

In contrast, quantitative studies emphasize the measurement and analysis of causal relationships between variables, not process. Proponents of such studies claim that their work is done from within a value-free framework.”

Quantitative research provides numerical and statistical data that typically answers questions such as: “how much?”; “how many?”; “how often?”. On the other hand, qualitative research results in data in the form of words in its effort to explain and explore. It tends to focus on questions such as “who?”; “what?”; “why?”. It is more interested in finding out what is happening and why. Chisnall (2001) contends that the essence of qualitative research is a search for a deeper understanding of factors, and that this deeper understanding is obtained by probing, rather than by counting.

Quantitative methods essentially entail a commitment to a systematic approach to investigations, in which the collection of data and their detached analysis in relation to a previously formulated research problem are minimal ingredients (Bryman, 1989). One major advantage of quantitative research is that it allows the researcher to investigate a phenomenon without having any influence on it or being influenced by it. The lack of contact with participants means that responses are value-free, unlike qualitative research where the researcher plays a more active role in the collection of data and is therefore value-laden. Quantitative analysis is, however, sometimes criticised for being decontextualised and failing to connect meaning to the participants’ lives and situations, such that its results can be general and overly simplistic (Brannen, 2005). On the other hand, a qualitative approach enables the researcher to obtain a deep understanding of the research issue from the interviewees’ perspective. Qualitative research tends “to sacrifice scope for detail” as it focuses on the participants’ understanding and interactions (Silverman, 2005, p.9). The findings from a qualitative study can be used to provide the researcher with additional insight into existing trends. Since the researcher is not detached from the data collection process, there is the risk that the researcher may put forward his/her own personal opinion at the expense of truly reflecting on the actual response of the participants (Tashakkori and Teddlie, 1998). The criticisms leveled at the two approaches are supported by Rocco *et al* (2003, p.23) who stated that:

“Purely quantitative research tends to be less helpful through its oversimplification of causal relationship; purely qualitative research tends to be less helpful through its selectivity in reporting.”

The traditional premise is that quantitative and qualitative methods are rooted within conflicting traditions and that therefore they cannot co-exist together in the same research

project. For example, one of the differences that is used in the incompatibility argument of the two methods is that that quantitative research uses a deductive process while qualitative implies an inductive process. However, research, whether qualitative or quantitative, tends to be an iterative process and involves both induction and deduction since “we move from ideas to data as well as from data to ideas” (Hammersley, 1992, p.48). Quantitative research is a scientific method that essentially restricts the variables of interest, measures them in prescribed ways and identifies the relationships between variables that are being investigated. Quantitative data analysis therefore adopts a mechanistic approach that has a non-judgemental basis, which takes the form of statistical inference (Howe, 1998). However, Huberman (1987) contends that it is easy to overestimate the degree to which quantitative studies are objective and scientific. Although quantitative techniques employ precise measurement and statistics, the statistical tests are only used after various judgments are made (such as what is to be construed as a valid measure of the variables of interest). The results of statistical analysis are, therefore, only as credible as their background assumptions and arguments (Howe, 1998).

In other words, quantitative designs still involve an element of qualitative judgements (Robson, 2011). Indeed, Campbell (1978) goes to the extreme of arguing that all research is grounded in qualitative data. The blending of qualitative and quantitative research is illustrated by Gueulette *et al* (1999, cited in Onwuegbuzie and Leech, 2005) when they found that over 40% of 300 randomly selected studies labelled as qualitative research did in fact use both qualitative and quantitative methodologies. According to Howe (1998, p.15):

“Questions about methodology remain, but they ought not to be framed in a way that installs abstract epistemology as a tyrant or that presupposes the moribund positivist-interpretivist split.”

Bryman (1992) suggested that the differences between qualitative and quantitative methods should be the rationale behind their combination:

“Otherwise there would be no point in even discussing the possibility of combining them. They each have distinctive characteristics that make the possibility of combining them especially attractive.” (Bryman, 1992, p.75)

4.4 A MIXED METHODS APPROACH TO RESEARCH

Mixed methods approaches are becoming increasingly popular (Robson, 2011). This surge in popularity could be partly attributable to weariness with the paradigm wars. However, it is mainly due to researchers appreciating that pragmatism provides a highly compatible theoretical underpinning to mixing the two types of methods in the same project (Robson, 2011).

A mixed methods approach to conducting research is one where the researcher uses both quantitative and qualitative research techniques during the data collection stage and/or analysis phases of a research study (Armitage, 2007; Creswell, 2003; Tashakkori and Teddlie, 1998). Tashakkori and Creswell (2007, p.4) define mixed method research as “research in which the investigator collects and analyses data, integrates the findings, and draws inferences using qualitative, and quantitative approaches, or methods in a single study or program of inquiry”. The research data may be collected either simultaneously or sequentially, with the decision being essentially based on the research questions that are to be addressed. The use of a mixed methods approach is seen as an appropriate way of decreasing weaknesses pertaining to both quantitative and qualitative research (Tashakkori and Teddlie, 1998).

Burke Johnson *et al* (2004, p.118) defined mixed methods research as “a class of research where the researcher mixes or combines quantitative and qualitative research techniques, methods, approaches, concepts or language into a single study” and considered it as the “third wave” or “third research movement” – a movement that moved past the “paradigm wars” by offering a logical and practical alternative.

Philosophically, mixed research is based on the use of the pragmatic method. The notion of a mixed methods approach was originally created by Campbell and Fiske (1959, cited in Rocco *et al*, 2003) who proposed mixing quantitative and qualitative methods so that psychological traits could be measured more precisely. The reason for mixing the two approaches was to ensure that the focus of the study was on the trait itself, rather than on the method used. The mixing of the two approaches was later labeled as “triangulation” by Denzin (1978). The objective of using the two methods was not meant to derive the

same result with different approaches, but rather to serve as a test of consistency and also provide complementarity. Triangulation provides a way of checking and boosting the results if the same results are obtained from different approaches. For complementarity purposes, results are used to complement each other, rather than just for checking and verification purposes. In this way, both overlapping phenomena as well as any phenomenon which is different from the rest of the data are identified (Rocco *et al*, 2003). Together the data analysis from the two methods are juxtaposed and can generate complementary insights, therefore creating a bigger picture. A mixed-method approach also helps to achieve cross-validation of data and avoid any information bias which could stem from the use of a single method of gathering data (Hussey and Hussey, 1997; Silverman, 2000). Brewer and Hunter (1989, p.17) state that it is a basic strategy:

“to attack a research problem with an arsenal of methods that have non-overlapping weaknesses in addition to their complementary strengths”.

The purpose for mixing methods is to provide “a better understanding of research problems than either approach alone” (Creswell and Clark, 2007, p.5). Many research questions are best answered by mixing methods having “complementary strengths and nonoverlapping weaknesses” (Johnson and Onwuegbuzie, 2004, p.18). Whilst quantitative research is weak in understanding people’s behaviour, qualitative research is not suited for making generalizable findings due to the greater chance of bias and smaller samples studied. Therefore, each of the quantitative and qualitative strands in mixed methods research has strengths that offset the weaknesses of the other strands (Creswell and Clark, 2007). Mixed method research therefore offers a better understanding of the problem being researched, by building on the strengths of the independent approaches and balancing their relative weaknesses (Jick, 1979).

Denscombe (2008) identified the key defining characteristics of the mixed methods approach as being the use of (i) quantitative and qualitative methods within the same project; (ii) a research design that clearly specified the sequencing and priority that is given to the quantitative and qualitative elements of data collection and analysis; (iii) an explicit account of the manner in which the quantitative and qualitative aspects of the

research related to each other; and (iv) pragmatism as the philosophical underpinning for the research.

The main advantages of using a mixed methods approach can be summarised as follows:

1. Narrative adds meaning to numbers, and numbers add precision to narrative. Indeed, using mixed methods in research is often useful because the findings of one can be supportive for the other. In fact, Hussey and Hussey (1997, p.72) argue that:

“It is not unusual in business research to take a mixture of approaches; particularly in the methods of collecting and analysing data... this allows you to take a broader, and often complementary, view of the research problem or issue.”

2. It can answer confirmatory and exploratory questions. The use of single approaches does not achieve this. It also provides a wider and deeper answer to the research question (Tashakkori and Teddlie, 1998). This is because the researcher is not confined to one single method or approach;
3. It can provide stronger evidence for a conclusion. This is achieved through convergence and corroboration of research findings emanating from the use of the two approaches (Creswell and Clark, 2011);
4. It can add varying viewpoints, insights and understanding that may have been missed when only one single method is used (Armitage, 2007).

In view of the above advantages, researchers are increasingly making use of a mixed method research methodology to strengthen their studies and findings (Rocco *et al*, 2003). In fact, mixed method research is increasingly being used across different disciplines and its application has been extended to many different research fields (for example, in nursing (Rogers *et al*, 2003) and in psychology (Johnson and Price-Williams, 1996). It offers researchers the possibility to resolve problems “using both numbers and words” and a combination of “inductive and deductive thinking” (Creswell and Clark, 2007, p.9-10). In addition, according to Maxcy (2003, p.59), “it is perfectly logical for researchers

to select and use different methods as they see the need, applying their findings to a reality that is at once plural and unknown”.

The use of mixed methods does, however, have present the researcher with certain challenges or issues. For example, it can be difficult for a single researcher to carry out both qualitative and quantitative research, especially if two or more approaches are used concurrently. The researcher must also be versatile with multiple methods and therefore possess a whole bag of skills that appertain to both qualitative and quantitative methods (Bryman, 2004). Their use is more expensive and more time consuming, and they are subject to the contention by methodological purists that one should always work with either a quantitative or qualitative paradigm. Furthermore, Bryman (2012) expressed concern over the lack of integration of findings in the writing of the research. Mason (2006, p.3) also expressed concern that mixed method designs can produce disjointed and unfocused research, advising that:

“[Researchers] need to have a clear sense of the logic and purpose of their approach because this ultimately must underpin their practical strategy not only for choosing and deploying a particular mix of methods, but crucially also for linking their data analytically.”

Mason (2006) also identified practical, political and resource issues as establishing certain constraints on the researcher wishing to carry out a mixed methods research project, including responsibilities to and expectations of funders and other stakeholders. A mixed methods approach cannot be considered as some soft option as there are a number of difficulties along this path.

In summary, the use of mixed methods provides the researcher with a number of advantages. At the same time, it also presents the researcher with a number of challenges: time involved in collecting and analysing text and statistical data, the breadth of the data collection required and the need to be versatile with both qualitative and quantitative approaches.

The objectives of the study stated in Section 1.2 can be achieved more comprehensively by first collecting and analysing quantitative data and subsequently collecting qualitative

data to explain the meaning of quantitative data in more depth. It is primarily for this reason, and to a lesser extent, due to the superiority of mixed methods over mono-methods, that a mixed methodology was adopted for the study. Such decision agrees with Johnson and Onwuegbuzie (2004), who argued that the choice of a mixed as opposed to a purist methodology offered the best chance of fully answering the research objectives of a study.

4.5 RESEARCH STRATEGY AND METHODS

Having established the methodological position of the study, the next stage involved related to developing the research strategy and identifying the methods that are consistent with its assumptions.

As suggested by Saunders *et al*, (2007, p.135):

“No research strategy is inherently superior or inferior to any other. Consequently, what is most important is not the label that is attached to a particular strategy, but whether it will enable you to answer your particular research question(s) and meet your objectives. Your choice of research strategy will be guided by your research question(s) and objectives, the extent of existing knowledge, the amount of time and other resources you have available, as well as your own philosophical underpinnings.”

A variety of different strategies have been proposed in using mixed methods. Three different strategies that may be used are the sequential exploratory strategy, the sequential explanatory strategy and the concurrent triangulation stratagem. A sequential exploratory design involves investigating a phenomenon qualitatively and from its analysis, the researcher forms quantitative questions. On the other hand, a concurrent triangulation design is one that uses both quantitative and qualitative methods simultaneously to confirm findings within a single study. Both these strategies are considered unsuitable to address the research questions of this study. The purpose of the study is to investigate the views of auditors and shareholders in Malta on the objective of financial statements and the message being conveyed through general purpose financial statements so as to analyse the existence of a financial statements expectations gap. A sequential explanatory

design is therefore considered appropriate for this study where the quantitative stage (establishing the views of the respondent groups) is followed by the qualitative one for the results and/or exceptions obtained in the quantitative phase to be investigated and probed in further detail. An explanatory mixed method design is defined as:

“a mixed methods design in which the researcher begins by conducting a quantitative phase and follows up on specific results with a second phase. The second, qualitative phase is implemented for the purposes of explaining the initial results in more depth” (Creswell and Clark, 2011, p.82)

This method can be illustrated diagrammatically as follows:

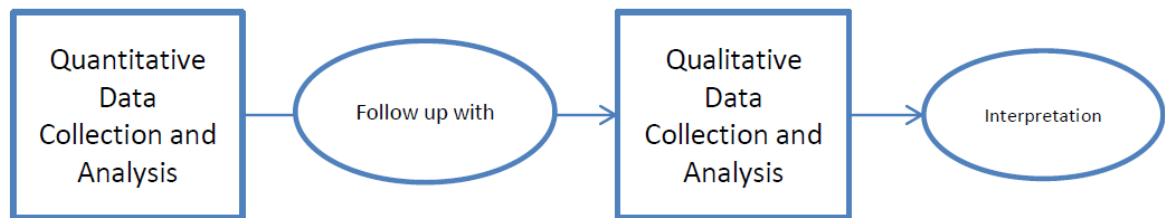


Figure 4.1: The explanatory sequential design

Explanatory research is a useful way of discovering what is really happening in the world in order to seek new insights, ask questions, and/or to assess phenomena in a new light (Saunders *et al*, 2009). It helps the researcher to better understand the problem or phenomenon being studied. It demands a flexible approach, wherein the researcher has to be able to adapt to change, even to the extent of changing the direction of the study as a result of new data that may appear or new insights that may be gained.

A fundamental aspect of this research study is the exploration of the views of auditors and shareholders in Malta on the objective and message of financial statements. To achieve this objective, it was considered important that the views of both parties are researched. The research design achieved this by collecting quantitative and qualitative data from both auditors and shareholders. The process of collecting data regarding the same phenomenon from multiple sources is known as data triangulation (Ryan *et al*, 2002). This process ensured that the various actors were given the opportunity to express their views and by comparing different sources, the validity of the findings was improved as subjective respondent category bias was reduced (Ryan *et al*, 2002).

This research study adopted a combined research approach that effectively mixed the deductive and inductive approaches. Deductive approaches are aimed at testing hypothesis about the same phenomena, while inductive approaches focus on deriving theories from data and patterns. The inductive approach starts from the observation of empirical events and then, gradually the explanations and theories based on the empirical observations are formulated. The data gathering process is usually followed by generalisations, such that the outcome from the research is not anticipated. On the other hand, the deductive approach develops a conceptual and theoretical structure (called a “hypothesis”) before any empirical observations (Jankowicz, 1995). The hypothesis is then tested through comparisons with the observed results. The deductive approach is the dominant research approach in the natural sciences, where there are laws which present the basis of explanation, as they allow the anticipation of phenomena, predict their occurrence and therefore permit them to be controlled. These two approaches (inductive and deductive approach) are clearly very different.

Creswell (2003) summarized the main differences between deductive and inductive approaches to research as illustrated in Table 4.2.

Induction emphasises	Deduction emphasised
<ul style="list-style-type: none"> * Scientific principles * Moving from theory to data * Collection of quantitative data * Application of controls to ensure validity of data * Operationalisation of concepts to ensure clarity of definition * Highly structured approach * Researcher independence of what is being researched * Necessity to select samples of sufficient size in order to generalise conclusions 	<ul style="list-style-type: none"> * Gaining understanding of the meanings human attach to events * Close understanding of the research context * Collection of qualitative data * Flexible structure to permit changes of research emphasis as the research progresses * Realisation that the researcher is part of the research process * Less concern with the need to generalise

Table 4.2 – Inductive and deductive approaches

Notwithstanding the fact that there are differences between the two approaches, it is possible to successfully combine the two approaches. For example, Blaikie (2003)

indicated that the combination of both strategies was feasible. By combining the two approaches, the advantages of the two approaches were combined together. As Bryman (2012, p.26) stated:

“As deduction entails an element of induction the induction process is likely to entail a modicum of deduction. To a large extent, deductive and inductive strategies are possibly better thought of as tendencies rather than a hard-and-fast distinction”.

Research, particularly in the field of social sciences, requires the researcher to move back and forth between data and theory. In the case of this research study, the deductive approach was important for the purpose of reviewing the existing literature on the subject matter, and therefore identifying the research gap in the field. In this way, the research questions and the techniques used in data collection were developed. The inductive approach was subsequently used to extend knowledge in an area that was not really explored in prior literature, and this was done on the basis of the research data that was collected. A deductive stance was therefore taken in the first phase of this study and an inductive one was taken in the second phase of the study. As already explained, literature has focused almost exclusively on the “audit” expectations gap, with little attention being given to the “financial statements” expectations gap. This therefore turned out to be a process that first started with theory, but then moved on to the development of research questions, followed by data collection and analysis, and then finally back to the theory stage at the end of the study.

To achieve the research objectives and answer the research questions, this study therefore employed one research strategy: the survey strategy. Other research strategies exist, such as grounded theory, ethnography and experiments; however, the survey was considered to be the most appropriate option to adopt. It is a popular and common strategy in business and management research and also allows the collection of a large amount of data from sizeable populations in a relatively economical way. Two data collection methods were used as part of the survey. These are the use of survey questionnaires and personal interviews. These methods will be described in the next sections of this chapter. The quantitative findings and qualitative results are first analysed separately in Chapters

5 and 6 respectively, but these are then interpreted jointly in the light of each method. This is the objective underlying the final discussion in Chapter 7.

A distinction is made between cross-sectional design and longitudinal design studies. A cross-sectional design study is one where the research about a particular phenomenon is conducted at a specific point in time (Saunders *et al*, 2012). On the other hand, a longitudinal study is “typically used to map change over time” as a sample is surveyed more than once (Bryman and Bell, 2015, p.66). In view of time limitations and higher costs involved, longitudinal design studies are seldom used in business research (Bryman and Bell, 2015). In the light of this, it was decided that this study would make use of a cross-sectional design.

Table 4.3 lists the design specifications of the research methodology used in this research. Such specifications are presented in the logical order of the “research onion” (Saunders *et al*, 2009, p.138).

Item	Description
Paradigm foundation	<i>Pragmatism</i>
Research approach	<i>Deductive followed by inductive</i>
Research choice	<i>Mixed methods</i>
Time horizon	<i>Cross-sectional</i>
Fixed-emergent continuum	<i>Combined (fixed and emergent) - the design was planned before the start of the research (fixed element) but the actual interview schedule used in the second phase emerged from the first phase (emergent element).</i>
Mixed methods design type	<i>Two-phase explanatory</i>
Data collection	<i>Phase 1: self-administered web / mail questionnaire</i> <i>Phase 2: non-standardised one-to-one face-to-face semi-structured interviews</i>
Timing	<i>Sequential: quantitative, followed by qualitative</i>
Full design name	<i>Two-phase explanatory sequential mixed-methods research design</i>

Table 4.3: Mixed methods research design specifications

4.5.1 QUESTIONNAIRE SURVEY

A questionnaire survey is one of the most widely used techniques by researchers in collecting primary data. In fact, in a number of studies, questionnaires have been utilised in order to identify and describe various phenomena, as well as to examine and explain relationships between different variables (DeVaus, 2002). According to Denscombe (2003, p.6), “the word survey means to view comprehensibly and in detail. In another sense, it refers specifically to the act of obtaining data for mapping”. The use of survey questionnaires involves administering a group of questions to a sample of respondents to obtain data about the respondents’ attitudes and opinions concerning the subject of the research.

The use of survey questionnaires as a research method has a number of advantages and disadvantages. Questionnaires are able to reach a large number of a population in a relatively short period of time and are cost effective (Jones *et al*, 2008). They are particularly suitable for explanatory or analytical research, allowing the researcher “to examine and explain relationships between variables, in particular cause-and-effect relationships” (Saunders *et al*, 2007, p.356).

Despite these positive attributes, questionnaires are also associated with a number of issues, typically the low response rates and the retrieval of incomplete responses (Jones *et al*, 2008). Furthermore, questionnaires limit and shape the nature of the responses and the researcher is unable to probe the responses. Moreover, certain sensitive questions may lead to potentially lower response rates or misleading responses in an attempt to hide unacceptable behavior (Buchman and Tracy, 1982). Oppenheim (2000) and DeVaus (2002) argued that researchers cannot be certain that the right contact person was actually responding to the survey questionnaire in the case of mail or web-based surveys. Questionnaires may also offer little opportunity to the researcher to check or corroborate the truthfulness of the answers given by the respondents, particularly when sensitive questions are involved. Burgess (2001) made a number of suggestions for mitigating the disadvantages of questionnaires: carefully planning and designing the questionnaire in an appropriate manner to maximise effectiveness, whilst at the same time keeping costs low and simplifying the analysis of the results.

Questionnaires can be administered in four main ways: through the post, by interview (face-to-face), by telephone or by e-mail. Postal questionnaires require the researcher to mail the questionnaire with a covering letter, normally enclosing a self-addressed envelope for the return of the completed questionnaire. The personal delivery of questionnaires ensures that respondents can be assisted in overcoming difficulties with the questions and it therefore enables the researcher to devise more complex questionnaires (Walliman, 2001). However, the personal delivery of questionnaires also has a number of disadvantages primarily related to time constraints and the limitations on the scope and extent to which this method of delivery can be used. Questionnaires can also be administered over the phone – this can be convenient and much less expensive than face-to-face interviews. However, there remains a bias as the respondents will be any person having a telephone and willing to answer questions asked by someone whom they never met. Moreover, telephone surveys are viewed as being prone to sampling and interviewer biases and are generally considered appropriate for short and simple questionnaires.

There were a number of reasons why a survey questionnaire was chosen to collect data in this study. Data from survey questionnaires is usually gathered relatively quickly and efficiently. It is comparatively not expensive to implement. Furthermore, questionnaires that include standardised close-ended questions facilitate the completion of the survey. It also allows the respondents to answer the questions at their time and pace, thus helping to boost the number of responses. In addition, in view of busy schedules, respondents may not be readily available to respond using other data collection techniques that may be more time consuming. Anonymity also helps to contribute to lower non-return bias since respondents are more willing to give out their true preferences. A relatively high literacy is generally required to participate in self-administered questionnaires. In this study, this is not considered to threaten the internal validity of the study – auditors are highly educated, while shareholders are considered to have a sufficient basic knowledge of the subject through their investment in the listed companies. A low response rate is generally considered to be the most threatening source of bias when using self-administered questionnaires.

This study has administered the survey questionnaires as follows: a web-based survey questionnaire was used for auditors, whilst a mail questionnaire was used for shareholders. Web-based surveys have become relatively easy to set up, with a number of web-sites available to facilitate the process. The advantage of using web-based questionnaires is that they can be used to collect data easily from a wide audience at no cost. Furthermore, since internet penetration is very high within the audit profession, it has been considered that web surveys are the best available tool to allow easy accessibility to the sampled auditors. Furthermore, given the availability of e-mail addresses of auditors, it was decided that a web-based approach would be utilised.

In the case of shareholders, as will be explained in Chapter 5, e-mail addresses could not be readily obtained from publically available information such as the register of members filed at the Registry of Companies. A postal survey questionnaire was therefore used. This method still benefits from allowing the respondents to complete the questionnaire at the time and place of their preference. It was also considered appropriate given the fact that internet use may not be so widespread within the shareholder base of listed Maltese entities as would be the case of auditors needing to use IT-based technology (including e-mails) in the ordinary course of their day-to-day work.

There are two main groups of statistical techniques that can be in a study – parametric and non-parametric tests. The choice of which technique to adopt essentially depends on the type of data and the scales that are included in the study. Parametric analysis is designed to be used when data is normally distributed. It is used with numerical data (data whose values can be measured numerically as quantities) and the data cases selected for the sample should be independent. Furthermore, the population from which the data cases are drawn should have equal variances. On the other hand, non-parametric statistics are designed to be used when data is not normally distributed. It is normally used with categorical data (data whose values can be classified into sets or placed in rank order) (Saunders *et al*, 2009).

Although parametric statistics are considered to be more powerful because they use numerical data, a number of assumptions need to be satisfied. For example, the use of

parametric statistics is based on the assumption that the population from which the sample is drawn is normally distributed and that data is collected on an interval or ratio scale. In social science research, however, attributes to be measured may not in fact be normally distributed and the data may be collected on an ordinal scale.

A commonly used software package that is used to analysis quantitative data is IBM SPSS Statistics for Windows. This can be used to perform a descriptive analysis of the results in order to obtain the mean score for all statements included in the questionnaires and the frequency of the answers given. Descriptive analysis is used to describe the basic features of the data in a study. It provides summaries about the sample and the measures, and forms the basis of every quantitative analysis of data. It therefore helps to simplify large amounts of data and present it in a meaningful way such that patterns might emerge from the data.

Statistical software can also be used in order to compare the responses from two or more respondent groups. In considering the statistical techniques to be used in this study for examining relationships and differences, reference was made to parametric and non-parametric statistics. As will be explained in Chapter 5, both parametric and non-parametric tests were used in this study. Since the respondents were from different categories (auditors and shareholders), the t-test and Mann Whitney U-test were used to identify differences between the groups that are significant at a 5% level of significance. Conclusions were drawn only where both tests revealed significant differences.

The t-test is a parametric statistical test used to determine the probability or likelihood that the values of a numerical data variable for two independent samples or groups are different (Saunders *et al*, 2007). The Mann Whitney U-test is the non-parametric alternative to the t-test. These tests were used to identify statistically significant differences in the responses, and these differences were then used to develop the interview schedule used at the subsequent qualitative stage of the study.

4.5.2 THE INTERVIEWS

Different research methods were considered for the purpose of collecting data for the qualitative part of the study. The advantages, disadvantages and appropriateness of each method, were duly considered.

For example, action research, which requires the researcher to develop a deep and potentially long-lasting relationship with the data subject (Saunders, 2012), was not considered appropriate given that the research questions are aimed at various recipients and are not meant to be covered in detail by any one particular auditor or shareholder. Ethnography, which requires the researcher to live with the research subject for a prolonged period of time (Saunders, 2012), was similarly not considered appropriate in view of time considerations and also because of the nature of the research questions being studied. Consideration was given to the possibility of using case study research by combining interviews between key representatives of the two respondent groups in the study (for example, combining an interview between a representative of a shareholder association and an auditor). However, after obtaining some preliminary feedback from possible participants, it was decided that this approach would not be adopted on the basis that interviewees would be more willing to share their views openly on an individual basis, particularly where debatable issues arose. Historical research was also considered, but this was not deemed to be able to address the research questions.

The use of interviews was therefore considered to be the most appropriate research instrument that can collect data that will answer the research questions and meet the research objectives.

Personal interviews were therefore used as another data collection technique in this study. Direct personal interviewing ensures that adequate thought and attention is given by the respondent when answering the questions (Hague and Jackson, 1999; Kalton and Moser, 1971). Interviewing also allows greater flexibility and the opportunity for probing and obtaining supplementary information (Emory, 1976). Interviewing is a flexible form of data collection. This flexibility makes interviewing suitable for a broad range of research situations (Sullivan, 2001). It also provides the opportunity for both parties involved (the

interviewer and the interviewee) to understand the questions and answers in a clear manner. The interviewer can explain the questions that the interviewee may not readily understand, while the interviewee is encouraged to give more accurate and complete information. Interviews also allow the interviewer to perceive the interviewee's response at the time of answering the questions. This may include, for example, the interviewee's emotional reaction to the questions or the attitude towards the questions being asked. This represents additional information that will enable the interviewer to better evaluate the responses given, particularly in those cases where the subject matter is highly personal or arguable (Gorden, 1987 quoted in Sullivan, 2001). According to Patton (2002), interviews can capture certain elements such as thoughts, feelings and intentions that cannot be measured or captured using other methods.

Gill and Johnson (1991) identified a number of advantages in using interviews as a data collection technique. For example, an experienced interviewer can assess the interviewee's outlook and use this to discuss the interview questions in greater depth, therefore leading to more in-depth responses as opposed to brief shallow answers. An experienced interviewer can also assess the non-verbal responses given by the interviewee. Such non-verbal responses may include, for example, body language or facial expressions. This also represents data that is useful to the researcher, and it can be very useful in inferring meanings that are not expressed verbally by the respondent.

Whilst interviews can be useful in collecting high quality information and a number of advantages can be related to their use, the use of interviews as a research instrument also poses certain limitations and disadvantages. Interviews are time-consuming. They require a lot of preparation and commitment by the researcher, particularly in terms of the onerous task of transcribing the interview and identifying the emerging themes. Gaining access to participants for the interview is also not easy, particularly because of possible demanding work commitments and also because of organisational politics that may restrict access to the interviewee.

Interview methods can be sub-divided into three forms: structured, semi-structured and unstructured (Hancock, 1998). A structured interview is one where the interview

schedule consists of a set of tightly structured questions that are administered to each interviewee. Data is collected systematically and this enables comparability. In a structured interview, the interviewer reads out each question to the interviewee and records the responses received in a standardized schedule, generally with pre-coded answers. Furthermore, in order to avoid interviewer bias, the interviewer should read the questions on a verbatim basis, avoiding making any modification to the questions and also using the same tone of voice. In a semi-structured interview, the interview schedule includes a predetermined list of questions or matters to be discussed and explored during the interview. The interview schedule serves as an outline of what needs to be covered during the interview.

As opposed to structured interviews, semi-structured interviews are not standardized. When using semi-structured interviews, the researcher makes use of a pre-determined list of questions. However, from one interview to another, the questions or the sequence of the questions may be changed, depending on the flow of the conversation. Some questions may even be omitted while others can be added. The use of semi-structured interviews provides an opportunity for the interviewer to alter the sequence of questions or probe for more information from the participants, depending on their level of understanding. The interviewee is allowed to talk freely about his beliefs and experiences. Indeed, it is the interviewee's perceptions on the subject matter that will guide the conduct of the interview (Saunders *et al*, 2007). Finally, an unstructured interview or "informal conversational interview" (Patton, 2002, p.342) is the most open ended method of interviewing based on questions that are not planned. This type of interview is used when the interviewer considers it necessary to maintain maximum flexibility and therefore be responsive to individual differences and situational changes.

There are four ways in which data collection using interviews can be obtained, namely face-to-face interviews, telephone interviews, focus group interviews and using applications that provide video chat/voice calls, such as Skype or Viber. When compared to face-to-face interviews (which are usually undertaken on a one-to-one basis), a focus group interview involves a number of people being involved at the same time. Although focus groups can be beneficial because it provides the researcher with the opportunity to

work with a group of people's ideas (Stroh, 2000), this approach was not considered appropriate as it may discourage some participants from expressing their real views openly. Telephone interviews, on the other hand, is a pre-scheduled interview that takes place between the interviewer and the interviewee over the telephone. In this study, telephone interviews were not considered appropriate since it was considered difficult to encourage participants to talk without the physical presence of the researcher. In addition, telephone interviews were also considered inappropriate as the interviews were expected to be relatively long ones. Furthermore, in view of the availability of participants to take part in a face-to-face interviews, using Skype or Viber to conduct the interviews was not deemed necessary.

In this study, the second research method used for data collection is the semi-structured interview, conducted on a face-to-face basis. The semi-structured interview can be seen to lie between the two extremes of the unstructured and the structured interview. It leaves time for further explanations and clarifications, whilst at the same using specific questions in an open-ended format. The semi-structured interviews enabled the interviewees to express their views openly where debatable issues arise, thus better bringing to light the perceptions of the two respondent groups and highlighting any disagreements between respondents. By using semi-structured interviews, the interviewer was in a position to determine the topics or subject areas to cover, yet at the same time being open to any new insights or additional information that may emanate from the interviewees. Another important aspect of using semi-structured interviews is that this approach enabled the interviewer to follow up the responses rather than just taking them at face value. Emphasis was placed on what the respondents say, and therefore direct quotations were a very important aspect of the study.

The decision to opt for interviews as the research instrument for the qualitative phase of the study was also based on adequate consideration being given to answering the research questions that were outlined in the first chapter. It was concluded that such questions could not be answered only through the analysis of numbers, but that the research study needed to uncover discussions with the data subjects and therefore encourage the respondents to "open up" with their view to the researcher.

Access to interviewees was not considered to present any significant issues. The researcher, through his past involvement in the audit profession as well as through his appointment on certain committees of the local institute, has built strong contacts with audit practitioners in the field. The researcher is also involved as a financial controller with a privately owned group of companies and therefore has access to a number of potential interviewees for the shareholder group too. Moreover, the Department of Accountancy at the University of Malta (where the researcher holds a part-time lecturing appointment) has strong links with both the auditing profession and the business community in Malta. Accordingly, access to audit practitioners and shareholders was considered to be readily available.

Responses to the personal interviews were transcribed in those cases where permission to record the interview was granted by the interviewee. The process of transcribing helped the researcher to think about and start analysing the data, being aware that “transcription is an integral process in the qualitative analysis of language data” (Lapadat and Lindsay, 1999, p.1). According to Halcomb and Davidson (2006), the transcribing process brought researchers closer to their data. Based on the research objectives of the study, it was considered that verbatim transcriptions would be made, typing the exact words of the interview, transcribing all sections of the interview and only omitting small pauses and inaudible words. In those cases where the interviewees expressed their preference not to be recorded, the salient points from the interview were faithfully reproduced and summarised by the interviewer. At the end of the transcription process, the transcripts were re-read to improve familiarity with the data and notes were drafted in search for the main themes emerging from the interviews. These were analysed to identify apparent relationships between themes and uncover connections in way that enabled the research findings to be backed up with empirical evidence. The initial themes were established based on the issues that were included in the interview schedule. However, these were later refined as the analysis of data progressed and patterns emerged.

There are several tools or packages available on the market to help a researcher in analysing qualitative data (for example, MAXQDA <http://www.maxqda.com>, Atlas.ti <http://www.atlasti.com> and Nvivo www.qsrinternational.com/nvivo-product). One of the

most popular software used by qualitative researchers is Nvivo, and authors are increasingly recommending its use (e.g. Bazeley, 2007). It is designed for use when the researcher has large volumes of data in the form rich text-based data that requires a deep level of analysis. Nvivo is a tool that can be used to organize, manage and report on qualitative data, and it is a relatively user friendly software that does not require intensive training to learn how to use it. It requires the researcher to develop a set of themes or categories, and to go through the transcriptions in order to code and categorise the large amount of narrative information available. In this way, through the coding process, the large volume of qualitative data is reduced into a more manageable set of categorized data based on the identified themes. Nvivo software also facilitates the storage, coding, retrieval, comparing and linking of data (Patton, 2002). In this study, Nvivo was used by the researcher for its functionality and ease of use (Richards, 2002).

4.5.3 VALIDITY IN QUANTITATIVE AND QUALITATIVE RESEARCH

The validity of the data that is collected through survey questionnaires depends very much on the design of the questions, as well as on the structure of the questionnaire (Saunders *et al*, 2009). Validity refers to the ability of the questionnaire to measure what the researcher intended to measure. It is concerned with whether the right thing is being measured and whether the findings are being measured accurately. Joppe (2000, p.1) defined validity by stating that it:

“determines whether the research truly measures that which it was intended to measure or how truthful the research results are. In other words, does the research instrument allow you to hit “the bull’s eye” of your research object? Researchers generally determine validity by asking a series of questions, and will often look for the answers in the research of others”.

Generally speaking, there are two key types of validity in a quantitative study: external validity and internal validity. External validity refers to the extent to which the findings of a particular study can be generalized across populations, contexts and time. On the other hand, internal validity refers to the extent to which the researcher is confident about the conclusion/inferences of the causal relationship between variables/events (Tashakkori and Teddlie, 1998). It is therefore considered that important attention needs to be given

to the design of the questionnaire (as explained in Section 5.2.1) in order to ensure that the means of measurement is appropriate and is actually measuring what it is intended to measure. Accordingly, in the design of the questionnaire, experts on the subject were duly consulted and asked to provide their input on the questionnaire.

For qualitative research, some commentators argue that it may be more appropriate to develop an entirely different set of criteria to assess validity instead of traditional criteria used in quantitative studies (Johnson and Onwuegbuzie, 2004). Thus, for example, whilst it is relatively easy to assess external validity, which emphasises the generalisation of findings, in a quantitative study, it is more problematic to assess this in the case of qualitative studies. This is because of the small samples often used in qualitative studies. As Bryman (2004, p.285) argues, “the findings of qualitative research are to generalize to theory rather than to population”. Thus, in qualitative research, data is gathered from multiple cases to build up theory with a view to eventually transferring conclusions or generalizations to other contexts (Tashakkori and Teddlie, 1998). There are also different approaches that can be undertaken to improve generalization in qualitative research. For example, Bryman (1989) suggested that studying more than one case is a helpful solution to improve generalisation. Furthermore, Parry (1998) argued that gathering multiple perspectives on the same incident can help to moderate the negative impact of single sources on research validity. The use of two sets of interviewees, therefore, is helpful to enhance validity. These factors were duly taken into consideration in this study with a view to enhancing the validity of the data collected. Accordingly, Section 6.3 explains the number of cases that were included in the study, and it also describes the two sets of interviewees.

4.5.4 RELIABILITY IN QUANTITATIVE AND QUALITATIVE RESEARCH

Reliability assesses the degree of consistency if repeated measures of the variable are made. It is therefore concerned with whether the findings of the research study are repeatable or not. In other words, reliability represents the extent to which different researchers, using the same methods, can obtain the same results as those of a previously conducted study. Reliability refers to the extent to which:

“results are consistent over time and an accurate representation of the total population under study is referred to as reliability and if the results of a study can be reproduced under a similar methodology, then the research instrument is considered to be reliable”. (Joppe, 2000, p.1)

According to Charles (1995), the extent to which scores or responses to questions in a questionnaire are relatively the same can be determined through the test-retest method at two different points in times. As explained in Section 5.2.3, the test re-test reliability approach was therefore used at the pilot stage in order to ensure the validity of the questionnaire. This attribute of the research instrument is also referred to as stability. A stable research measure should result in similar results being obtained at different points in time, indicating that the results are repeatable.

In qualitative research, reliability tends to be more of a contentious issue. Human beings and human behaviour are not static, and it is therefore difficult to replicate a qualitative study in this sense. This does not mean that reliability is not relevant for qualitative research. In fact, alternative ways of addressing reliability have been suggested by different social researchers (e.g. Silverman, 2001). LeCompte and Goetz (1982) argued that replicability necessitates an accurate identification and detailed description of the strategies adopted to collect and analyse data. This precise identification and thorough description of the strategy is referred to as the “audit trail” by Franklin and Ballan (2001). This study explains the research methods adopted for the purpose of collecting data in Section 6.2. Similarly, the interview procedures and the data analysis process are also discussed clearly in Section 6.3. In addition, as explained in Section 6.4.2, the researcher also tried to check the accuracy of the data collected by sending the transcripts or notes of the interviews back to the participants and getting their feedback.

4.5.5 RELIABILITY AND VALIDITY – MIXED METHODS RESEARCH

This study adopted a mixed methods approach. The combination of the qualitative and quantitative approach has the potential to achieve triangulation, which is one of the important ways to enhance external validity. Bryman (1988) argued that combining quantitative and qualitative approaches can enhance the generalization of the researchers’

findings if “they can be shown to provide mutual confirmation” (Bryman, 1988, p.131). By examining the views, using both quantitative statistical techniques and qualitative interpretation, of the two groups mainly involved in the financial reporting process, it is possible to achieve consistency in some findings, and thus increase the external validity of the overall research. Although this study seeks to enhance external validity by combining quantitative and qualitative methods, generalization still remains a limitation in the qualitative part of the study.

4.6 ETHICAL CONSIDERATIONS

The ethical dimension is an important consideration throughout the research process. Research ethics is interested in the analysis of ethical issues that are raised when people are involved as participants in research. Research ethics need to be given due attention during all stages of the research journey: the formulation of the research area, gaining access to the data, data collection, processing and storing data, data analysis and presentation of findings. All these stages need to be guided by a moral and responsible approach by the researcher. This means that the researcher must, for example, avoid exposing participants to stress, asking participants for information that can be detrimental to their self-interest, or involving participants in research without their prior consent. Ethical issues apply to both quantitative and qualitative research.

Ethical clearance from the Ethics Approval (Human Participants) Sub-Committee at Loughborough University was obtained before the questionnaires and interview schedule were circulated. This was done to ensure that the study is free from any ethical violations or harm that might be caused to participants.

The researcher has strived to follow high ethical standards in the conduct of the research study. Thus, for example, for the personal interviews, respondents were informed that they were chosen on the basis of their relative experience, knowledge and expertise. They were also encouraged to participate actively in the interview because it could assist the audit profession and the business environment in Malta, and were also promised access to the final summary results once the study was concluded. Assurances were also given

that confidentiality and anonymity would be observed and that the information acquired in the data collection part of the study would be solely and exclusively used for research purposes. Being voluntary participants, they were also reminded of their right to withdraw their involvement in the research at any time during the execution of the interview. It was also explained to participants that being part of a doctoral programme at Loughborough University, the study had the prior approval of the ethics committee of the University.

In order to achieve the above objectives, the following approach was adopted when conducting the semi-structured interviews:

1. Participants were first given a brief introduction on the subject matter and the purpose of the interview was explained.
2. It was explained that the interview findings would be aggregated with those of other participants and would be employed to develop relevant findings on financial reporting in Malta.
3. It was clarified that the participant's participation was completely voluntary, and that therefore the participant was free to withdraw participation in the interview at any time without giving any reason.
4. Confidentiality and anonymity – it was re-iterated that all information provided would be anonymous. None of the information provided would be linked to a participant and for this reason, no questions were asked on name, residential address, marital status, educational attainment or other personal matters. This was done so as to make it impossible for anyone to identify a respondent in the study.
5. An undertaking was given that the interview would be kept private and confidential. It was explained that although it would be extremely valuable to audio-record the interview, the participant was free to decline. However, it was explained that any audio-recording would be destroyed after it has been

transcribed and after the study is concluded. The transcripts would be stored securely and anonymously on a computer that is password protected. Access to the data will be restricted to the researcher and to his supervisor.

Accordingly, in view of the great effort undertaken to ensure confidentiality, the interviewees were solicited to provide honest and complete answers to the interview questions, particularly in those cases where debatable issues arose. Interviewees were encouraged to be frank and direct in their responses.

The above matters were included in a signed “information sheet” that was distributed to the interviewees before the start of the interview.

Ethical considerations were likewise also kept in view for the purpose of the mail survey. The respondents’ anonymity was preserved as they were not asked to disclose any personal details, such as their names, surnames or identity card numbers. The questionnaire’s introductory letter explicitly stated that participation was voluntary.

Furthermore, the mailing addresses of local shareholders to whom the questionnaire was sent by post were obtained from the register of members of listed companies. These registers are publically available documents, and can easily be accessed either from the online portal of the Registry of Companies or else by visiting in person the offices of the Registrar of Companies at Mriehel, Malta. These addresses were only used for the purpose of including the details on the envelope; no reference was included on the actual printed questionnaire included in the envelope. Each completed questionnaire was regarded as evidence of the respondents’ informed consent to use the provided information for research purposes.

Moreover, the questionnaires and the interviews did not include any question or requests for information on sensitive issues that could cause harm, discomfort or embarrassment to the participants. As already explained, all questions were pilot tested before the actual data collection process so as to identify any questions that could possibly give rise to ethical issues. The participants were also allowed to take their time in answering their

questions – the web/mail survey was responded to by participants at their own leisure, while during the interview, no time pressures were exerted on the participants. In addition, the interview schedule was always sent ahead of the interview allowing the respondent enough time to go through the questions ahead of the interview.

During the interview itself, the researcher showed interest in the responses being received; at times, when the researcher noted that the questions were misunderstood, the question was repeated and explained to the interviewee, paying particular attention not to give any negative signals or showing any signs of disbelief or disappointment. This was particularly applicable in the case of interviews with shareholders who were not technically competent in the subject of accountancy. Objectivity was also maintained during the data analysis stage to ensure that no omission of data or misrepresentation of data was made, such that the data analysis would represent a faithful analysis of the findings collected.

4.7 CONCLUSION

This chapter has set out the methodology and methods that have been adopted for the purpose of this study.

It has discussed some philosophical approaches that are pertinent to research and has also provided with a justification for its methodological stance based on the pragmatist approach and a mixed methodology framework. The methodology and techniques used at each stage of the research process have also been presented and evaluated. This chapter has therefore presented the foundation of the research approach. The next two chapters present the data collection and analysis for the survey questionnaires and interviews respectively.

CHAPTER FIVE – QUESTIONNAIRES: DATA COLLECTION, ANALYSIS AND RESEARCH FINDINGS

5.1 INTRODUCTION

This Chapter focuses on the collection and analysis of the quantitative data used for the purpose of this study. It is divided into two parts: the first part of the Chapter (Section 5.2) focuses on the survey research, covering the design of the research instrument, the pre-testing and piloting stage, the sample selection process and administration of the questionnaire. The second part of the Chapter (Section 5.3) subsequently presents the research findings emanating from the quantitative part of the study.

5.2 SURVEY RESEARCH

This Section elaborates on the questionnaire design and the pre-tests / pilot study that were undertaken to assess various aspects of the research strategy and the survey instrument. It also focuses on the choice of the survey population and sampling frames. It subsequently describes the response rates and the process used for the analysis of the data.

5.2.1 QUESTIONNAIRE DESIGN

The quality of the questions as measures and the questionnaire format / layout are factors that heavily weigh on the quality of the data collected. The starting point in the design of the questionnaires necessitated referring back to the research objectives of the study (Section 1.3) and establishing the information that would need to be elicited from the respondents in order to achieve these objectives. Two sets of questionnaires were drafted, one set for use with the auditors and another set for use with the shareholders. The questionnaires mainly consisted of a number of statements where respondents were asked to indicate their views on a Likert-scale. The questionnaire included fifty statements in two main sections, followed by a personal background section. Full copies of the questionnaires are attached in Appendix 1.

For the survey questionnaires, a five-point Likert-style rating scale (“strongly agree” – “agree” – “neutral” – “disagree” – “strongly disagree”) was used. The term “neutral” has been issued to capture responses where the respondent neither agrees nor disagrees with a statement being made. Likert scales are the most popular scaling technique used in survey research (Babbie, 1998). A Likert scale has the advantage of being relatively easy to construct and administer, and also facilitates the process of data analysis (Bryman, 2012). Research findings show that the use of this scale is reliable and valid (Oppenheim, 2000) and also extremely useful with large data sets (Robson, 2002). An odd scale was used to allow respondents who have no opinion or knowledge on the matter to tick the “neutral” option. In selecting the number of points of a rating scale, a trade-off has to be made between the precision with which the scale can record opinions and the measurement error. Whilst adding more points to a rating scale enables it to capture data more precisely, it becomes more cumbersome for respondents to use, thus increasing measurement error (Lee and Paek, 2014; Preston and Colman, 2000). Therefore, the researcher utilised a five-point Likert scale for all rating questions for consistency (Saunders *et al*, 2009).

A nominal scale was used to measure close ended questions and other demographic variables. The use of close ended questions enhances the comparability of answers, and reduces the possibility of variability in the recording of answers given by respondents, making it particularly useful in surveys (Tull and Hawkins, 1993). One general open-ended question was included at the end of survey in order to enable more creative responses/comments to be elicited, allowing respondents to share their knowledge and experience on the subject matter being explored by the current study. Open ended questions allow respondents to give answers in their own way (Fink, 2003). They allow an unlimited number of possible answers where respondents can answer in detail and can qualify and clarify responses given. Open ended questions therefore permit creativity, self-expression, and richness of detail, which are important ingredients when one wants to “find out what is uppermost in the respondent’s mind” (Saunders *et al*, 2009, p.375).

In designing the questionnaire, attention was duly given to ensuring that the questionnaire was not too long or vague or having unnecessary lines of questioning. Since one of the

disadvantages of self-administered questionnaires is that the researcher cannot explain questions to the respondent (Fox *et al*, 2003; Saunders *et al*, 2009), utmost care was exercised to ensure that the questions were as straightforward and unambiguous as possible. Furthermore, in order to maximise the chances of success in collecting responses, the following approach was adopted: each section of the questionnaire was given a short meaningful title; the questionnaire was kept as short and succinct as possible; different headings and colours were used to make it easy and attractive for the respondent to answer. Clear instructions on how to respond to the questions were given. The questionnaire also included background information on the researcher and the research area, outlining the purpose of the survey and why the response was important. It also confirmed that all the answers would be treated with confidentiality and anonymity.

No leading questions were included in the questionnaire. Furthermore, the words used in the questions were selected carefully – words like “generally” or “regularly” were avoided as people’s idea of what is general or regular can vary significantly. Technical jargon was kept to a minimum, whenever possible, to ensure that the language used catered for the relevant level of literacy (particularly for the shareholder group). In terms of the order of questions, it was decided to put the most important questions in the first half of the questionnaire.

Questions were structured in such a way as to start with easy and “non-threatening” questions so as to encourage respondents to carry on with the questionnaire. Demographic and personal questions were included in the last section of the questionnaire. Finally, appropriate font size was used so as not to squeeze the questionnaire into a small number of pages, therefore providing plenty of space between one question and another so that the questionnaire does not look too “busy”.

The questionnaires were written in English. Although the study is being conducted in Malta, a country having its own native language (Maltese), it is widely accepted in Malta that English is the language in which business and commerce in their widest form are

conducted. Consequently, no need was identified for the questionnaire to be translated and administered in Maltese.

The questionnaire used in the study consisted of four sections as illustrated in Table 5.1.

Section Heading	Statement Number	Respondent Group
Section 1: The objective of financial statements	1 to 28	Auditors and Shareholders
Section 2: The understandability of financial statements	29 to 50	
Section 3: The use of financial statements	51	
Section 4: General information	52 to 58	Auditors
Section 4: General information	52 to 60	Shareholders

Table 5.1: The structure of the questionnaire

The statements that were included in the questionnaire were mainly derived from the accounting and auditing literature. The questionnaire was designed from the information presented in Chapter Two to collect the data required to achieve the research objectives stated in Section 1.3 within the research setting (Malta).

The link between the different sections of the questionnaire and the research objectives is illustrated in Table 5.2 below:

Research Objective	Sections in Questionnaire	Research Objective
<i>To investigate the views of auditors and shareholders in Malta on the objective of financial statements</i>	Section 1 – Statements 1 to 28 Section 3 – Statement 51	<i>To analyse the possible existence of a financial statements expectations gap in a small state economy such as Malta</i>
<i>To identify the respondents' perceptions on the message being conveyed through audited general purpose financial statements</i>	Section 2 – Statements 29 to 50	

Table 5.2: The link between the research objectives and the structure of the questionnaire

One of the key ingredients of effective communication is identifying the message that needs to be communicated, and hence establishing the objective of financial statements was start off point of the questionnaire. The first section of the questionnaire therefore focused on the objective of financial statements and it included twenty-eight statements dealing with this aspect of the study. In this section of the questionnaire, respondents were asked to indicate their views on the objective of financial statements and the message being communicated in financial statements. The statements that were included in this section therefore sought to elicit the views of respondents on a number of aspects such as the current objective of financial statements as outlined by standard setters, the use of financial statements to monitor past performance and predict future performance, the short-term and long-term focus of financial statements and reporting on the efficiency, economy and effectiveness with which company resources are used. This section also included statements on truth and fairness, stewardship and the audit function in order to evaluate the respondents' views on them.

The second section then focused on the understandability of financial statements, with a further twenty-two statements covering various facets of the communicative value of financial statements. This section therefore focused on aspects such as whether financial statements are read and understood by shareholders, and whether respondents considered them to be an important communications link in the financial reporting process. It also focused on the complexity of financial statements, the use of technical jargon, the current format and content of financial statements and the education aspect.

The third section dealt with the use of financial statements, requesting respondents to rank in order of importance the main uses of financial statements. Based on the literature review, six main uses were identified. These comprised the following: "decision-making", "predicting future cash flows", "assessing stewardship", "tax purposes", "communicating financial information" and "valuation purposes". Respondents were advised that in answering this question, "1" denotes the factor that is most significant while "6" denotes the factor that is least significant.

The last section of the questionnaire sought to gather demographic and other data related to the respondents of the survey. The participants were asked to provide background information by answering some personal questions using nominal scales. In the case of auditors, the requested information included gender, age group, work sector and specialization, and the number of years for which the respondent has been in possession of a practicing certificate in auditing. For shareholders, the information requested in this section consisted of gender, type of shareholder, age group, level of education, the number of years for which the investment has been owned and the number of investments held at any point in time.

5.2.2 PRE-TESTING AND PILOT TESTING

Pre-testing the research design and piloting it on a small scale before embarking on the major research project to collect the data provides the researcher with the opportunity to determine whether the main survey is worth executing and whether it will yield the desired results (Babbie, 1998; Oppenheim, 2000). Pre-testing and pilot testing provide a check on the research instrument and methodological procedures, and are therefore a critical stage of the research process. They are even considered important when using a tried and tested research instrument as they enable the researcher to assess whether the research instrument is relevant to the population in question and whether it is capable of obtaining the data required for the research being undertaken. The size and design of the pilot test is essentially a matter of judgment, and in practice, it is very much influenced by time and money considerations.

The questionnaire was pre-tested with one auditor, one shareholder and an ad hoc session was also held with an academic specialising in auditing and financial reporting at the University of Malta. The selection of the candidates for the pre-test was based on purposive judgment so as to be informed on the different aspects of questionnaire design. The respondents were given a draft questionnaire which they duly filled in. At the same time, they verbally explained how they interpreted the survey questions and formulated the answers. The questions were found to be comprehensible and could be answered readily. Fowler (2002) recommended that one of the best ways to pretest a questionnaire

was to have the questionnaire personally administered and then to engage in a discussion on its various facets. Thus, following the completion of each questionnaire, the respondents were probed by the researcher to explain how they went about answering the questions and whether the questions were easy or difficult to answer. Furthermore, a post-mortem review of the answers given was done, followed by a discussion on the appropriateness of the questionnaire design and structure. Following this process, an improved revised version of the questionnaire was created, and this version was then used for the subsequent pilot test.

A pilot test was made before administering the questionnaire to the sample selected. The objectives of this pilot exercise were to identify any ambiguities in wording, ensure that the questions were understandable to the respondents and to ascertain whether the research objectives could be attained from the responses given to the questions set. According to Berg (1995), pilot testing helped to detect poorly framed questions. Teijlingen and Hundley (2001) argued that a pilot test ensured that the researcher does not collect a lot of useless information. It provided a good way to refine the research instruments and helped make any changes to the research instruments before the data collection actually started (Creswell, 1998). Saunders *et al* (2009, p.394) opined that the objective of a pilot test was “to refine the questionnaire so that respondents will have no problems in answering the questions and there will be no problems in recording the data”.

The questionnaire in the revised format following pre-testing was developed electronically using SurveyMonkey.com (see Section 5.2.4 below) in the first week of October 2015. The idea was to administer the questionnaire in the same identical manner as would be undertaken for the final data collection stage. An invitation to participate in this pilot test was therefore sent to ten auditors and ten shareholders. Moser and Kalton (2001, p.51) suggested that the size and design of the pilot survey is a matter of “convenience, time and money”. The pilot study was directed at a representative sample of the population, with the respondents being again selected on the basis of purposive judgment. The participants were asked to complete the questionnaire and provide their feedback. The questionnaire used for the pilot study included an additional ad hoc section at the end of the questionnaire which elicited feedback from the respondents. This last

ad hoc section was subsequently removed from the final version of the questionnaire. The participants in the pilot study were asked to provide their feedback to the questionnaire by also answering four key questions: “*Were the instructions on how to answer the questionnaire clear enough?*” “*How long did it take you to complete the questionnaire?*” “*Were there any questions that you consider to be ambiguous or unclear?*” and “*Was the layout of the questionnaire a user-friendly one?*”

No significant issues were identified in the pilot stage that could affect the various facets of the questionnaire design or data analysis. Certain minor adjustments and improvements to the questions set were reflected and included in the resulting final questionnaires. Practical observations from the pilot study therefore helped to shape the final draft of the questionnaires.

The test re-test approach was also used at the pilot stage in order to ensure the validity of the questionnaire. This method requires that the questionnaire is delivered and completed twice by a small sample of the population (Saunders *et al*, 2012). Eight of the respondents participating in the pilot study completed their second questionnaire within one week after having completed the first one. The Kendall’s Tau test was used to assess the test re-test reliability of the questionnaire. The rationale of using this test is that the rating evaluations have an ordinal scale. The null hypothesis specifies that there is a poor test re-test reliability and is accepted if the p value exceeds the 0.05 level of significance. The alternative hypothesis specifies that there is a satisfactory test re-test reliability and is accepted if the p value is less than the 0.05 criterion. The vast majority of the replies had satisfactory test re-test reliability, with p-values below the 0.05 criterion.

Pilot testing the questionnaire therefore helped to ensure the validity of the questionnaire. This procedure also confirmed that the time required to complete the questionnaire was reasonable and that the questions were suitable for the intended purpose of what they purported to measure. It was therefore concluded that the research instrument was a valid one to use in the study and that the administration of the questionnaire could therefore proceed.

5.2.3 SAMPLE SELECTION

Publically available data was used in this research study. The sampling frames for the current study consisted of the following:

(i) *External Auditors*

Reference was made to the portal of the Maltese Accountancy Board in order to ascertain the number of auditors having a practicing certificate in auditing, as well as obtaining contact details. This portal can be accessed on the website of the Maltese Accountancy Board which is available at <https://secure3.gov.mt/accountancyboard/>. As of the 20 October 2015, there were 2,311 registered auditors and accountants in Malta. This population comprised 1,225 registered auditors (having a practicing certificate in auditing) and 1,086 registered accountants. The registered auditors include inter alia audit partners, audit managers, audit seniors, and practitioners in medium and small sized practices. It also includes auditors working in firms with international affiliation (such as the Big Four audit firms), as well as sole practitioners. This study focuses on the population of 1,225 registered auditors having a practicing certificate in auditing, therefore being eligible to conduct statutory audits and sign off audit reports. The Maltese Accountancy Board portal only contained limited information (name, surname, warrant number and locality) on registered auditors. When asked for further personal details (such as contact e-mail addresses), an officer from the Accountancy Board cited data protection issues that precluded the Board from sharing such information, even for research purposes.

A search for the auditors' e-mail addresses was therefore performed on the members' directory from the Malta Institute of Accountants website. The list of e-mail addresses that was obtained from the members' directory was initially scrutinized for duplicate listings. This procedure yielded a total of 1,745 e-mail addresses as at 20 October 2015. Registered auditors are generally also members of the local institute, albeit that it is a known fact that some registered auditors are not members. Furthermore, there are some members of the MIA that are not registered auditors or accountants as they may have opted not to apply for the warrant to practice as an accountant and/or for the practicing

certificate in auditing. These factors explain the difference between the 1,225 registered auditors and the 1,745 e-mail addresses obtained from the MIA members' directory.

An attempt was made to try and match the list of e-mail addresses with the names of the registered auditors obtained from the portal of the Accountancy Board. This however proved to be a laborious exercise and one that was very much prone to errors, especially considering that the e-mail address may not always include the full name and surname of the recipient.

It was therefore decided that the 1,745 e-mail addresses would be used and that two questions would be added in the electronic version of the questionnaire asking participants to confirm whether they are registered auditors having a practicing certificate in auditing. In this way, the study would focus on the responses given by registered auditors, whose population, as already stated, amounted to 1,225 as of 20 October 2015.

(ii) *Shareholders*

Share registers as at 20 October 2015 for public limited liability companies were obtained from the Registry of Companies at the Malta Financial Services Authority. Partnerships (such as partnerships en nom collectif / en commandite) have been excluded in this study. The population for the purpose of this sampling frame was considered to be listed companies, namely public companies whose shares are listed on the Malta Stock Exchange. Such companies would have a more widespread investor base that would generally be found in Maltese private companies which are generally characterised by ownership and management being vested in the same person/s or groups of persons, typically family relations. It is important to note that Maltese investors may also own shares in overseas companies. Information on such shareholdings is not publically available and it was therefore not possible for the researcher to track such investments. Accordingly, this study focuses on persons holding shares in Maltese listed companies.

As of the 20 October 2015, there were twenty-two companies whose shares were listed on the Official List of the Malta Stock Exchange, and one company (listed last in Table

5.3) on the Alternative Company List (ACL). The ACL is a MSE initiative aimed at providing listing opportunities for companies who may not be in a position to fulfill the more rigorous requirements of a mainstream MSE Official Listing. Its objective is to provide a platform for a secondary market for companies without an established track record, and/or those that would otherwise not qualify for a listing on the Official List. The companies on the Official List and ACL operate in various sectors, such as information technology, banking, insurance, property, telecommunications and hospitality. Table 5.3 shows the listed companies in Malta as of 20 October 2015.

Bank of Valletta p.l.c	HSBC Bank Malta p.l.c
Lombard Bank Malta p.l.c	Mapfre Middlesea p.l.c
Simonds Farsons Cisk p.l.c	GO p.l.c
International Hotel Investments p.l.c	Plaza Centres p.l.c
Global Capital p.l.c	FIMBank p.l.c
Malta International Airport p.l.c	Santumas Shareholdings p.l.c
Medserv p.l.c	Grand Harbour Marina p.l.c
6pm Holdings p.l.c	MaltaPost p.l.c
RS2 Software p.l.c	MIDI p.l.c
Malita Investments p.l.c	Tigne Mall p.l.c
Pefaco International p.l.c	Malta Properties Company p.l.c
Loqus Holdings p.l.c	

Table 5.3 – Listed entities on the MSE’s Official List and Alternative Company List

The website of the Registry of Companies, accessible on <https://registry.mfsa.com.mt/>, enables the user to access data on limited liability companies in Malta. It is a user-friendly website where the user can search for information and also download documents (e.g. memorandum and articles of association, annual returns and financial statements) that companies have submitted to the Registrar of Companies for filing. It also includes a search facility that allows the user to search either by company name or by company number. Given that the names of the listed companies were available, the individual records of each listed company were accessible by keying in the company name.

In view of the limited number of equities that are listed on the Maltese stock market, it was decided to obtain the share registers of all the listed entities so as to ensure that the sample selected would be representative of the Maltese investor base having shares in listed companies operating in different industries. The last available share registers were therefore retrieved electronically from the website of the Registry of Companies. Each share register included the following information for every shareholder: name, surname, address and shareholding.

The registers of the listed entities, particularly the large capitalisation ones, included many individuals. They also included a number of institutional, nominee and overseas shareholders, which were excluded from the survey population. The registers were not available in an electronic format that could facilitate the analysis of investors. In fact, the information was available in a read-only format, generally in Adobe format. Some of the registers were high quality scanned print-outs, but others were scanned documents having an inferior quality. An attempt was made to try and convert the pdf documents into Excel format in order to consolidate the data in Excel worksheets. However, given the poor quality of some scans and also the difficulty in transposing the data to Excel, it was decided that hard copies of the registers would be used for the purpose of the sample selection. This resulted in voluminous print-outs being generated. For example, the share register of the two main listed banks (HSBC Bank Malta p.l.c. and Bank of Valletta p.l.c.) included over 110 pages and over 400 pages respectively.

It is expected that, based on the principle of diversification of investments, investors would hold more than one investment. Given the limitation associated with the format of the share registers explained above, it was not possible to determine the exact number of investors. However, from a review of the lists and from a desktop exercise carried out by the researcher, it is estimated that there are more than 50,000 individuals in the shareholder group. An approximate confidence interval for the proportion of positive outcomes of a binary variable is given by:

$$P = p \pm z_c \sqrt{\frac{p(1-p)}{n}},$$

where P is the population proportion, p is the sample proportion, n is the sample size, and z_c is the critical percentile corresponding to the required level of confidence. The term following the \pm sign can be considered to be an error in the population proportion. If this error is required to be less than E , one would then get the inequality:

$$z_c \sqrt{\frac{p(1-p)}{n}} \ll E,$$

or equivalently,

$$n \geq \frac{p(1-p)z_c^2}{E^2}.$$

Taking $E = 0.05$, $z_c = 1.96$ for a 95% level of confidence, and a proportion p in the region of 0.5, one obtains the inequality

$$n \geq 385.$$

This would be the smallest sample size to guarantee an error of at most ± 0.05 in the population proportion. Accordingly, $n = 385$ shareholders were randomly selected (using a systematic random sampling technique) from the share registers. Systematic sampling is a technique for creating a random probability sample in which each piece of data is chosen at a fixed interval for inclusion in the sample. The aim of the systemic random sampling is to reduce the potential for human bias in the selection of cases to be included in the sample. It is also easy to administer. In this case, the first item was selected using a random number generating process and then the other shareholders for the sample were selected at intervals of 130. In order to use this approach, shareholder registers were sorted in alphabetical order by reference to the name of the listed company. Shareholders were then sequentially numbered and a sample of shareholders was accordingly chosen.

5.2.4 QUESTIONNAIRE ADMINISTRATION

The implementation of the research design is a key stage of the research study. No matter how good the research design is, the ultimate success of a study depends on its implementation. According to Babbie (1998, p.186), “a brilliant research design that is improperly executed will result in failure”.

The final questionnaire was programmed electronically using SurveyMonkey.com, which is an online survey development tool that provides free and customisable surveys for users. It is a very easy to use web-based tool, especially considering the ease with which surveys can be created and circulated to respondents by e-mail. It allows the user to create, deploy and also analyse survey results using on-line available tools. It is a free on-line tool, albeit that a subscription is required to be able to utilize the service over a period of time. Different plans (for example, monthly or annual plan) are available, depending on the needs of the user. In the case of this study, a monthly plan was utilized and this was renewed from one month to another during the course of the survey and its analysis.

Once the questionnaire was finalised and programmed electronically, a hyperlink to the questionnaire was generated. This is a link to the questionnaire that respondents can click on to be able to access the questionnaire and then submit the responses back to SurveyMonkey.com, where all the responses are stored. The responses are accessible only to the person who created the questionnaire (the “owner” or “administrator” of the survey). In addition, the website also sends regular updates to the researcher with responses being received and provides certain interesting feedback to the researcher. For example, it shows in a graphical manner the collection of responses over time, both on a daily and cumulative basis. The website also allows the researcher to create an information sheet at the start of the questionnaire. This was used to explain the purpose of the study and also to provide assurance to the respondents about the confidentiality of the responses. It also included certain instructions to respondents to guide them in answering the questionnaire, and finally thanking them for the participation in the study. Respondents were also encouraged to contact the researcher in case of any issues in

accessing the questionnaire using the hyperlink or in case of any difficulties in answering the questions.

In the case of the auditor group, the aforementioned hyperlink was sent via e-mail to all the 1,745 e-mail addresses retrieved from the MIA Directory (Section 5.2.1). The e-mail included a brief description of the topic under study. It assured participants that their responses were confidential and anonymous, and that the data would only be used for research purposes only. Participants were encouraged to pro-actively participate in the survey because it was directly relevant to their profession and would assist financial reporting considerations in Malta. They were also promised access to the final summary results once the study was concluded.

For the shareholder group, as explained in Section 5.2.3, since e-mail addresses were not readily available, a hard copy of the questionnaire was printed and sent by post to the selected sample of 385 shareholders. As explained in Section 5.2.3, the shareholders were selected using systematic sampling. In those situations where more than one individual resided at the same address (for example, a father and his son), it was decided to only send one questionnaire to the first listed individual at each address. A covering letter was included outlining the purpose of the study. To facilitate matters for the participants, a stamped self-addressed envelope was also included.

The questionnaire was self-administered for convenience and to reduce the possibility that respondents answer in a manner that they think pleases the researcher. Additionally, this setting safeguards anonymity which helps respondents to answer confidential questions honestly (Buchman and Tracy, 1982). In addition, in order to minimise the fear that they may be scrutinized or judged on their answers, the respondents were re-assured about the confidentiality of the responses and also that there were no right or wrong answers to the questions posed. Respondents were encouraged to be honest and objective in answering the questions. Such steps helped to reduce the risk that respondents may modify their responses to appear more acquiescent, socially desirable or in line with how they perceive that the researcher would like them to answer.

In order to solicit the respondents' participation, an e-mail was sent to the auditors two weeks after the launch of the survey to remind them to participate in the survey. Personal contacts in audit firms were also followed-up and a number of phone calls were made encouraging participation. Personal contact, through the presence of the researcher who can encourage participation in the survey, increases the possibility of improving response rates without necessarily introducing interviewer bias. Furthermore, a highly literate surveyed population (auditor respondent group), which is well versed with the subject matter, and which has a professional interest in the enquiries being made, is more likely to complete surveys. Respondents were thanked for their contribution to the study, especially considering the fact that the survey coincided with various other surveys being conducted by University students for the purpose of their dissertations.

In the case of the shareholder group, it was not considered beneficial to send reminders to the participants in view of the anonymity of the responses and also taking into account the significant cost associated with sending out such reminders by post. The initial feedback from the launch of the survey to respondents was low, and it was therefore considered that increasing the number of questionnaires sent out would help to improve the number of responses received. A further sample of 385 shareholders was therefore selected using the same approach as outlined in Section 5.2.3 and another set of questionnaires were mailed to the selected shareholder group. This process had to be repeated iteratively, such that a total of 1,400 questionnaires were sent out in four batches between November 2015 and February 2016. The Christmas period was avoided in view of the significant increase of postal mail at the time, and also due to the Christmas vacation period.

In addition to the mail survey, a convenience sampling technique was used in the case of shareholders. Bryman and Bell (2015, p.200) defined convenience sampling as "one that is simply available to the researcher by virtue of its accessibility". One main issue with the use of convenience sampling is that using only this technique makes it more difficult to generalize findings, as the researcher may not know of what population his/her sample is representative (Bryman and Bell, 2015). Nonetheless, Bryman and Bell (2015, p.201) claimed that it is acceptable to use convenience sampling when collecting data using such

a method since it “represents too good an opportunity to miss”. In addition, in this study, convenience sampling was not the “only” technique used, but it was used to complement the mail survey. Accordingly, questionnaires were distributed to shareholders with whom the researcher has personal contact. Shareholders were advised that the responses were to be sent back to the researcher in the self addressed envelope, and the questionnaire was filled in, if at all, independently and not in the presence of the researcher. In certain cases, a hand-delivered, hand-picked strategy was considered the best way to increase the probability of successful participation. In such cases, personal contact increases the possibility of a response without necessarily introducing interviewer bias as the presence of the researcher was limited to delivering the research instrument and picking up the response at a later date. This latter strategy was only adopted for a small number of participants as most respondents contacted through personal contact replied in the enclosed self-addressed envelope.

The quantitative data of this study was collected over a period of three months. The questionnaires to auditors and shareholders were first dispatched on 27 November 2015 and the last completed questionnaires were received on 22 February 2016.

5.2.5 QUESTIONNAIRE RESPONSES AND MARGIN OF ERROR

As shown in Table 5.4, a total of 497 questionnaires were completed, 243 by registered auditors and 254 by shareholders.

	Auditors	Shareholders
Responses received from web-based survey	293	-
Usable responses received from mail survey	-	254
Distribution of survey	1,725	1,400
Response rate	16.9%	18.1%
Usable responses received from registered auditors (out of the 293 responses)	243	
Distribution of survey	1,725	
Response rate from registered auditors	14.1%	

Table 5.4 – Total usable responses and response rates

Table 5.4 shows that a total of 293 responses were received from the web survey conducted using the e-mails extracted from the MIA members directory (as explained in Section 5.2.3). This equates to a response rate of 16.9%. After excluding responses from MIA members who are not registered auditors, the usable responses decreased by 50 for a total number of 243 responses in this category. The decrease reflects respondents who may have received the web survey (being included in the MIA members directory) but who are not in possession of the practicing certificate in auditing. The number of 243 responses therefore represents the final number of responses received from warranted accountants having a practicing certificate in auditing, and therefore eligible to perform statutory audits in Malta. Given that, as explained in Section 5.2.1, the total number of auditors as of the cut-off date amounted to 1,225, the 243 responses represent 19.8% of the total registered auditor population in Malta.

The response rates for the two groups were achieved following the various follow-up e-mails and data collection efforts referred to in the previous Section. Furthermore, the above response rates are quoted after checking the questionnaires comprehensively for completeness. Questionnaires with incomplete values were considered unusable. Also, in certain cases, the hard-copy questionnaire received by mail had missing pages or too many missing values, and were therefore likewise considered unusable.

The response rates are considered to be satisfactory. The auditors' response rate was obtained in a far easier manner when compared to the data collection efforts that had to be deployed for the shareholder group. A highly literate surveyed population, which is generally familiar with questionnaire surveys and which understands the relevance of the enquiry to its profession, is more likely to complete and return the questionnaire (Greene and Caracelli, 1997). The auditors' response rate is in line with the response rates generally achieved by research students at the Department of Accountancy at the University of Malta. Auditors were also more prone to participate in the survey, which is indicative of the willingness of audit practitioners to readily participate in studies that may be of direct relevant or interest to their profession. The response rate from shareholders is still, however, considered to be satisfactory, particularly compared to the normal response rates for postal questionnaires, which generally is expected to be almost ten per cent (Oppenheim, 1992). In fact, the response rate from shareholders compares well to the response rates reported by several recent surveys (e.g. Graham et al, 2005; Brav et al, 2001).

The margin of error expresses the maximum expected difference between the true population parameter and a sample of that particular parameter. For a 95% degree of confidence $z = 1.96$, σ_p is the standard error (standard deviation of the sampling distribution of proportion), which is given by (Freund *et al*, 2014):

$$\sigma_p = \sqrt{\frac{p(1-p)}{n} \left(\frac{N-n}{N-1} \right)}$$

p is an known population proportion and σ_p is maximized when $p = 0.5$. Given that the sample size of auditors is $n = 243$ respondents and the population size is $N = 1225$, then the maximum value of the standard error σ_p is:

$$\sigma_p = \sqrt{\frac{p(1-p)}{n} \left(\frac{N-n}{N-1} \right)} = \sqrt{\frac{(0.5)(0.5)}{243} \left(\frac{1225-243}{1225-1} \right)} = 0.0287$$

$$\text{Maximum margin of error} = z\sigma_p = (1.96)(0.0287) = 0.0563 = 5.63\%$$

A sample size of 243 auditors selected from a population of size 1,225 auditors will therefore result in a maximum margin of error of 5.63%, assuming a 95% confidence level.

In the case of the shareholder group, for a 95% degree of confidence, given that the sample size of shareholders is $n = 254$ respondents, then the maximum value of the standard error σ_p is:

$$\sigma_p = \sqrt{\frac{p(1-p)}{n}} = \sqrt{\frac{(0.5)(0.5)}{254}} = 0.0314$$

$$\text{Maximum margin of error} = z\sigma_p = (1.96)(0.0314) = 0.0615 = 6.15\%$$

A sample size of 254 shareholders selected from an unknown population of shareholders will therefore result in a maximum margin of error of 6.15%, assuming a 95% confidence level.

A test for non-response bias was also performed. Non-responses can be caused by four interrelated problems: refusal to respond, ineligibility to respond, inability to locate respondent and the respondent being located, but the researcher being unable to make contact (Saunders *et al*, 2002). The approach undertaken to test for the non-response bias was to split each of the respondent groups into two sub-groups – “earlier” respondents compared to the “late” respondents. The early respondents were those that replied in the first thirty days from when the survey questionnaire was launched. On the other hand, the late respondents were those that replied after those thirty days had elapsed. The rationale for using this procedure is based on the premise that non-respondents are more likely late-respondents (Morgan, 1974). A comparison of early and late respondents would at least give an indication of any likely differences between those responding and those not responding. Chi Square tests were used to test for non-response bias. The results revealed that there were no statistical differences in the responses given by the different groups.

5.3 PRESENTATION OF FINDINGS

5.3.1 DATA ANALYSIS – THE PROCESS

Data was collected from the auditor respondent group in an electronic format. As a result, the answers to the questionnaires were exported from Surveymonkey.com and transformed into a suitable Microsoft Excel format. Microsoft Excel was used for the initial data inputting operations and to create separate worksheets containing the raw data appropriately being coded, as explained below. The process was a relatively quick one given that the responses from the auditor group were captured in electronic format at source.

In the case of the shareholder group, the answers given by shareholders had to be manually input into Excel. Every effort was made to ensure the accuracy of the data input process. In fact, the data was input twice into two different Excel worksheets. These were then compared to each other in order to ensure the accuracy of data input. This was the only method that could be used to transform electronically the answers given by shareholders to the hard copy questionnaires.

The quantitative data collected from the questionnaires was analysed using IBM SPSS Statistics Version 24 (SPSS). SPSS is an established and widely used computer application that is used for data processing, analytical reporting and graphical presentation of results. It possesses strong data handling and statistical capabilities. The online questionnaire was designed using Surveymonkey.com and this helped to ensure that the data was ready for analysis. For example, the online questionnaire did not allow respondents to miss or skip a question. Similarly, through the use of check-boxes, respondents were clearly guided with instructions on how to answer the questions. An initial review of the data showed that there were no missing values or errors in the data collected. As already explained in Section 5.2.5, questionnaires with incomplete responses were discarded. Qualitative data that was included in the open ended question was separately recorded and analysed.

The coding of the responses was fairly straightforward. As explained in Section 5.2.1, most of the statements used a five-point Likert style rating scale. The responses were coded as follows: “1” denoted “strongly disagree”, “2” denoted “disagree”, “3” denoted a “neutral” position, “4” denoted “agree” and finally “5” denoted “strongly agree”. For each statement therefore, the mean rating score ranges from “1” to “5”, where “1” corresponds to “strongly disagree” and “5” corresponds to “strongly agree”. The larger the mean rating score, the higher is the agreement with the statement, and vice-versa. Check-list questions were likely coded. For example, for the gender question, “1” was assigned to “Male” while “2” was assigned to “Female”. Similarly, for the age group, a number was assigned to each response, with “21-30 years” being assigned “1” and “61+ years” being assigned “5”.

A descriptive analysis of the results was then performed. Descriptive statistics, on their own, do not, however, allow the researcher to reach conclusions beyond the data that has been analysed or reach conclusions regarding any hypotheses that may have been made by the researcher. They are simply a way to describe the data collected, generally focusing on mean scores, medians, frequencies, measures of central tendency and measures of spread.

There are two main groups of statistical techniques that can be used – parametric and non-parametric tests. In this study, both parametric (t-test) and non-parametric (Mann Whitney U-test) were used and conclusions were drawn only where both tests revealed significant differences between the responses of the two respondent groups (“auditors” and “shareholders”).

The t-test compares the difference in means of the two groups using a measure of the spread of the scores. On the other hand, the Mann Whitney U-test compares the mean rank scores (mean ranks) of two groups in order to identify statistically significant differences. This is done by taking all of the scores for the two groups, rank ordering them and then computing the mean of the ranks in each group. This results in a mean rank for each of the two groups. If the distributions are identical, which is the null hypothesis of the Mann Whitney U-test, the mean rank will be the same for both groups.

However, if one group tends to have higher values than the other group, then the scores of that group will have been assigned higher ranks and will consequently have a higher mean rank (and vice-versa). It is this difference in mean ranks that is tested by the Mann Whitney-U test for statistical significance. This statistical test therefore determines whether there is a statistically significant difference in the mean ranks between the two groups.

The critical factor to consider is the p-value, which identifies the existence or otherwise of statistical differences. The effect size formula for Mann Whitney testing (shown below) was then used in order to provide a quantitative measure of the strength of the difference (Cohen, 1988; Ellis, 2010).

$$r = \frac{Z}{\sqrt{N}}$$

where:

r is the effect size;

N is the total number of the samples; and

Z is Mann Whitney's U score.

In interpreting the effect size, Cohen's (1988) guidelines for r were used, in that a large effect is 0.5, a medium effect is 0.3 and a small effect is 0.1.

In addition to the above, regression analysis was used in order to explore further the data collected. For certain statements considered to be critical by the researcher for the purpose of this study, regression analysis was used to test the determinants of the answer received. The results are reported in Section 5.3.4.4.

5.3.2 PARTICIPANT DEMOGRAPHICS - AUDITORS

The demographic profile of the surveyed respondents is based on selected variables, depicting certain variables such as age and gender. The objective of collecting such data

was not only to have a basic descriptive understanding of the surveyed respondents, but also to gain an insight on their ability to make evaluative judgments on the subject matter.

The majority of respondents in the auditor group were males. In fact, 180 responses (74.1%) were received from male auditors while 63 responses (25.9%) were received from female auditors.

Financial services-related posts in Malta, including but not limited to accountancy and auditing, remain predominantly occupied by males, albeit that the Maltese female activity rate in the labour force has been improving over the last few years, reaching a national record in 2014 with a percentage of 52.1% of women participating in the workforce, as was established by the National Statistics Office of Malta. The increasing participation by females is also evident from the increase in female students attending tertiary courses in business related subjects at the University of Malta.

Respondents were mainly within the “31 – 40” (49.8%) and the “41 – 50” (39.5%) age group. These two age groups in aggregate covered 89.3% of the total responses received. Although the auditing profession has been practiced in Malta for many years, it is only a total of 5.8% of the respondents that are older than 50 years. The vast majority of respondents are within the 31 to 50 age bracket, reflecting the experience that an auditor is expected to have in exercising his profession.

Table 5.5 provides a summary of the responses given to the “Age group” question.

Age group	Frequency	Per cent	Cumulative per cent
21 – 30 years	12	4.9%	4.9%
31 – 40 years	121	49.8%	54.7%
41 – 50 years	96	39.5%	94.2%
51 – 60 years	12	4.9%	99.1%
61 + years	2	0.9%	100%
Total	243	100%	

Table 5.5 – Age group (auditors)

The above results are in line with the answers given to the question focusing on the number of years that the respondent has been holding a practicing certificate in auditing. In fact, from the responses received, the respondents were also well experienced practitioners since over 73% of them held a practicing certificate in auditing for more than ten years. This was important for the purpose of the current study in order to ensure that as far as possible, respondents include auditors having appropriate on-the-ground audit experience. In addition, it is considered that auditors with more experience would be able to provide their inputs more appropriately. The total responses to the question focusing on the number of years for which the respondent has held a practicing certificate in auditing is analysed in Table 5.6 below.

Years	Frequency	Per cent	Cumulative per cent
1 – 5 years	11	4.5%	4.5%
6 – 10 years	53	21.8%	26.3%
11 – 20 years	97	39.9%	66.2%
21 – 30 years	78	32.1%	98.3%
31 + years	4	1.7%	100%
Total	243	100%	

Table 5.6 – Years holding a practicing certificate in auditing (auditors)

Auditors were fairly divided between the work sector of their current occupation. 33.7% of them worked in the “Other audit firm” category, while 29.6% worked with Big Four firms and 30% were engaged as sole practitioners. There are different types of audit firms in Malta, including the Big Four audit firms, firms having an international affiliation, partnerships and sole practitioners. The responses received are almost equally distributed between the three main types of audit firms and reflect the audit market in Malta. There are various reasons for this – Big Four audit firms are well known in Malta for their reputation and knowledge base that is critical when it comes to auditing bigger audit clients; at the same time, the Maltese business environment includes various family owned companies, which are smaller in size, and which tend to engage other auditors, such as medium sized firms and sole practitioners.

67.1% of respondents reported their main area of specialisation as being “Audit and Assurance”, with the remaining respondents being mainly concentrated in the “Accountancy” category (25.9%). The different work sector of respondents and their respective area of specialization are illustrated in Table 5.7 and Table 5.8 respectively.

Work sector	Frequency	Per cent	Cumulative per cent
Big Four audit firm	72	29.6%	29.6%
Other audit firm	82	33.7%	63.3%
Sole practitioner	73	30.1%	93.4%
Other	16	6.6%	100.0%
Total	243	100%	

Table 5.7 – Work sector (auditors)

Area of specialization	Frequency	Per cent	Cumulative per cent
Audit	163	67.1%	67.1%
Accountancy	63	25.9%	93.0%
Advisory	4	1.7%	94.7%
Management consultancy	1	0.4%	95.1%
Tax / legal	3	1.2%	96.3%
Other	9	3.7%	100.0%
Total	243	100%	

Table 5.8 – Area of specialisation (auditors)

The demographic data of the surveyed auditors suggests that they have the required qualities and experience to be able to make valued assessments and therefore contribute to this research. Any differences between these variables and their potential to influence survey results are examined later in this Chapter.

5.3.3 PARTICIPANT DEMOGRAPHICS - SHAREHOLDERS

The shareholder group was predominantly male, with 160 responses (63%) being received from males and 94 responses (37%) being received from females. Although the absolute majority of respondents again fell within the male category, this was at a lower percentage to that registered in the responses received from auditors. The vast majority of responses were received from investors who categorized themselves as “individual investors”. In fact, 227 responses or 89.4% of the responses from the shareholder group fell within this category. Table 5.9 shows the distribution of the frequencies for the type of shareholder.

Type of shareholder	Frequency	Per cent	Cumulative per cent
Individual	227	89.4%	89.4%
Institutional investor	23	9.0%	98.4%
Other	4	1.6%	100.0%
Total	254	100%	

Table 5.9 – Type of shareholder

Over 97% of the respondents were more than 40 years of age. Most of the respondents fell in the “51 – 60 years” (40.6%) and “61 + years” (38.6%) age bracket. The age distribution of the respondents within the shareholder group is reproduced in Table 5.10 below.

Age	Frequency	Per cent	Cumulative per cent
21 – 30 years	1	0.4%	0.4%
31 – 40 years	5	2.0%	2.4%
41 – 50 years	47	18.5%	20.9%
51 – 60 years	103	40.6%	61.4%
61 + years	98	38.6%	100.0%
Total	254	100%	

Table 5.10 – Age profile (shareholders)

85% of the respondents have confirmed that they have either a post secondary or a tertiary level of education, and 90 respondents (35%) confirmed that they had received formal education in the subject of accountancy. The remaining 164 respondents (64.6%) confirmed that they did not possess formal training in accounting. The responses received to the questions on the participant’s level of education and accounting knowledge/experience are shown in Table 5.11 and Table 5.12 respectively.

Level of education	Frequency	Per cent	Cumulative per cent
Primary	3	1.2%	1.2%
Secondary	35	13.8%	15.0%
Post secondary	130	51.2%	66.2%
Tertiary	86	33.8%	100.0%
Total	254	100%	

Table 5.11 – Level of education (shareholders)

Formal education in accounting	Frequency	Per cent	Cumulative per cent
Yes	90	35.4%	35.4%
No	164	64.6%	100.0%
Total	254	100%	

Table 5.12 – Formal education in accounting (shareholders)

More than 95% have indicated that they have held their investment for more than ten years, with the majority of responses (39.8%) falling in the “16 – 20 years” category. Table 5.13 shows the responses given to the question relating to the time period for which the investment was held by the shareholders.

Years	Frequency	Per cent	Cumulative per cent
0 – 5 years	2	0.8%	0.8%
6 – 10 years	9	3.5%	4.3%
11 – 15 years	65	25.6%	29.9%
16 – 20 years	101	39.8%	69.7%
21 + years	77	30.3%	100.0%
Total	254	100%	

Table 5.13 – Length of time for which investment is held (shareholders)

Apart from holding the investment for the longer term, the vast majority of shareholders (81.9%) have also confirmed that they invest in more than one company at any one point in time, with the highest percentage (39.8%) falling in the “2 – 5 companies” category. It was only 18.1% of respondents that confirmed that they were solely invested in one type of listed investment. Table 5.14 below presents the findings on the question asking respondents to confirm the number of companies that they invest in at any one point on time.

Number of investments	Frequency	Per cent	Cumulative per cent
1	46	18.1%	18.1%
2 – 5	101	39.8%	57.9%
6 – 10	74	29.1%	87.0%
10 +	33	13.0%	100.0%
Total	254	100%	

Table 5.14 – Number of investments held at any one point in time (shareholders)

Shareholders were also asked to advise the point in time when they considered financial statements as being more relevant to them. The majority of respondents replied that they considered financial statements useful either as a continuing shareholder (36.6%) or when they were about to purchase more shares in the investee company (39.8%). The remaining 17.3% referred to financial statements when considering to dispose of the shares, while only 6.3% stated that they never referred to them. Table 5.15 summarises the responses given to this question.

Usefulness of financial statements	Frequency	Per cent
As a continuing shareholder	93	36.6%
When you are about to buy shares	101	39.8%
When you are about to sell shares	44	17.3%
Never	16	6.3%
Total	254	100%

Table 5.15 – Usefulness of financial statements (shareholders)

Based on this information, the typical respondent shareholder profile that has emerged is that of a long term investor who typically holds onto investments for the longer term and who also invests in more than one investment with the objective of diversifying risk. Respondents are also not young investors, with the majority either being middle-aged or else approaching retirement age. Given that investments are generally held for more than ten years, it is likely that the investment would have been made by the shareholders during their working life, with a view to holding onto that investment for dividend returns and capital appreciation over time. The results reflect the predominant local shareholders' view of looking at shareholdings in listed companies as a form of long-term strategy aimed to earn a constant stream of dividends with no real intention to play the market to make capital gains (Grixti, 2013). Accounting education is also limited, albeit that formal education in other fields would have been received over the years.

For the shareholder group, from the demographic data collected, it can also be concluded that the characteristics of the surveyed shareholders suggest that they have the required qualities and experience to be able to contribute positively to this research study.

5.3.4 QUANTITATIVE RESEARCH FINDINGS

5.3.4.1 THE OBJECTIVE OF FINANCIAL STATEMENTS

Table 5.16 presents the mean rating scores, medians, minimum and maximum values and the results of the t-test and Mann Whitney U-test for the two respondent groups with respect to the statements contained in Section 1 of the questionnaire. It shows the results for the tests for significant differences between the responses of auditors and shareholders, and the effect size r being computed to determine the magnitude of the observed significant effects.

The statements showing a significant difference between the responses of the two respondent groups are shown with an asterisk (“*”) on the right hand part of Table 5.16, indicating that the responses received are statistically different at $p \leq 0.05$.

The Statement number on the left side of Table 5.16 refers to the number that was included in the original questionnaire sent to the two respondent groups, and will be referred to in the presentation of the findings in this Section.

The findings in Table 5.16 are presented in descending order (largest to smallest) based on the result of the effect size formula (r) for the Mann Whitney test.

		AUDITORS		SHAREHOLDERS		t-test p-value	Mann- Whitney p-value	Effect size r (Mann- Whitney)
		Mean Rating Score	Median (Min - Max)	Mean Rating Score	Median (Min - Max)			
20	Financial statements show whether a company has a sound internal control structure.	2.34	2 (1 - 4)	3.50	4 (1 - 5)	0.000	0.000	* 0.614
6	Financial statements show whether a company is well managed.	2.86	3 (1 - 5)	3.70	4 (1 - 5)	0.000	0.000	* 0.507
18	Financial statements show whether a company is a good investment or not.	3.06	3 (1 - 5)	3.87	4 (2 - 5)	0.000	0.000	* 0.448
24	An exercise of judgement is required in the preparation of financial statements.	4.02	4 (1 - 5)	3.33	3 (2 - 5)	0.000	0.000	* 0.446
7	Financial statements show the efficiency with which a company is being run.	2.95	3 (1 - 5)	3.69	4 (1 - 5)	0.000	0.000	* 0.442
21	The inclusion of an audit report enhances the credibility of a company's financial statements.	4.47	4 (4 - 5)	4.00	4 (2 - 5)	0.000	0.000	* 0.438
28	The primary use of financial statements is for use by bankers and providers of finance.	2.42	2 (1 - 4)	3.12	3 (1 - 5)	0.000	0.000	* 0.397
8	Financial statements portray management's ability to economically use the resources entrusted to it.	3.02	3 (2 - 5)	3.63	4 (1 - 5)	0.000	0.000	* 0.394
3	Financial statements enable shareholders to predict future performance and future cash flows of a company.	2.72	3 (1 - 5)	3.22	3 (1 - 5)	0.000	0.000	* 0.381
11	The objective of preparing financial statements is to compute and present the profit earned by a company during a reporting period.	3.53	4 (2 - 5)	4.01	4 (2 - 5)	0.000	0.000	* 0.365
22	The inclusion of other reports (e.g. chairman's statement) provides useful information to the shareholders.	4.06	4 (2 - 5)	3.57	4 (1 - 5)	0.000	0.000	* 0.325
25	Financial statements can achieve various objectives with the same set of figures.	3.98	4 (2 - 5)	3.54	4 (1 - 5)	0.000	0.000	* 0.301
14	The use of fair values and mark-to-market accounting provides more relevant information than historical cost accounts.	3.86	4 (1 - 5)	3.43	3 (2 - 5)	0.000	0.000	* 0.296
23	Financial statements present an accurate and complete picture of a company's financial performance and financial position.	3.37	3 (1 - 5)	3.81	4 (2 - 5)	0.000	0.000	* 0.288
4	The objective of financial statements is to assist investors in making economic decisions - whether to buy, hold or sell their investment.	3.60	4 (1 - 5)	3.94	4 (1 - 5)	0.000	0.000	* 0.288
2	Financial statements are useful to enable shareholders to monitor the past performance of a company.	4.33	4 (2 - 5)	4.02	4 (1 - 5)	0.000	0.000	* 0.247
1	The objective of financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.	4.34	4 (2 - 5)	4.04	4 (1 - 5)	0.000	0.000	* 0.234
27	The primary use of financial statements is for tax purposes.	2.33	2 (1 - 5)	2.74	3 (1 - 5)	0.000	0.000	* 0.232
26	An unqualified audit report implies that the financial statements are free from fraud.	2.48	2 (1 - 4)	2.86	3 (1 - 5)	0.000	0.000	* 0.222
15	Financial statements provide assurance to shareholders that a company has complied with the applicable rules and regulations.	3.57	4 (1 - 5)	3.24	3 (2 - 5)	0.000	0.000	* 0.215
16	The objective of financial statements is to ensure the accuracy and legitimacy of accounting records.	3.48	4 (1 - 5)	3.74	4 (2 - 5)	0.000	0.000	* 0.193
5	The objective of financial statements is to present a true and fair view of a company's financial performance and financial position for a reporting period.	4.37	4 (4 - 5)	4.20	4 (2 - 5)	0.000	0.001	* 0.149
19	Financial statements show whether a company is a going concern.	4.00	4 (3 - 5)	3.80	4 (2 - 5)	0.001	0.001	* 0.148
12	The audit of financial statements by an independent auditor ensures that financial statements are free of material errors, frauds or irregularities.	3.80	4 (1 - 5)	4.01	4 (1 - 5)	0.002	0.001	* 0.148
10	Financial statements provide information that enables investors to measure a company's long-term performance.	3.12	3 (1 - 4)	3.23	3 (2 - 5)	0.081	0.256	0.051
9	The objective of financial statements is to present a picture of the company's short-term performance.	3.45	4 (1 - 5)	3.43	3 (2 - 5)	0.678	0.469	0.032
13	The change in focus from the income statement (emphasising income and expenditure) to the balance sheet (emphasising the assets and liability approach) provides more relevant information to investors.	3.51	4 (1 - 5)	3.50	4 (1 - 5)	0.967	0.698	0.017
17	Financial statements enable shareholders to assess management's stewardship of the company's assets.	3.60	4 (1 - 5)	3.58	4 (2 - 5)	0.729	0.809	0.011

* significantly different between auditors and shareholders at $p < 0.05$

Table 5.16: Section 1 – The objective of financial statements

[Note: The findings are presented in descending order (largest to smallest) based on the result of the effect size formula (r) for the Mann Whitney U-test]

A particularly striking finding in the quantitative part of the study is the extent of statements showing statistically significant differences between the responses given by auditors and those given by shareholders. Table 5.16 shows that out of the twenty-eight statements included in Section 1 of the questionnaire, as many as twenty-four statements had statistically significant differences (both for the t-test and Mann Whitney U-test) in the responses given by auditors and shareholders at $p \leq 0.05$. It is also worth noting that the p-values for all the said twenty-four statements are well below the 0.05 level, generally at $p < 0.001$. The effect size for the Mann Whitney test, which is a way of quantifying the size of the difference between the two groups, has also resulted in twelve statements having a large effect and another twelve statements having a medium effect. Only four statements resulted in a small effect when using Cohen's (1988) guidelines (Section 5.3.1) for effect size r . These findings are therefore indicative of the different views of the two surveyed respondent groups, with the effect size showing the magnitude of the observed differences.

In order to be able to draw conclusions on the auditors' or shareholders' views on specific responses, one-sample t-tests were conducted to test whether the mean answer received is significantly higher or lower than the neutral value of three. This parametric test was performed so as to enable the researcher to determine whether, given sampling error, the mean answer for auditors or shareholders is significantly different from the "neutral" option (being "3" on the five-point Likert scale that was used in the questionnaire) and therefore be able to draw conclusions. This test was performed for each of the statements included in Section 1 and Section 2 of the questionnaire.

The results of this test are shown in Table 5.17. This test confirmed that conclusions can be drawn from the answers received for almost all of the responses given by auditors and shareholders. In fact, significant differences from the neutral value were noted across all the responses given by shareholders to the statements in Section 1 of the questionnaire. In the case of auditors, only three statements (Statement 7, 8 and 18), out of a total of twenty eight in Section 1, did not result in a statistically significant difference at $p \leq 0.05$.

		AUDITORS		SHAREHOLDERS	
		p value		p value	
1	The objective of financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.	0.000	*	0.000	*
2	Financial statements are useful to enable shareholders to monitor the past performance of a company.	0.000	*	0.000	*
3	Financial statements enable shareholders to predict future performance and future cash flows of a company.	0.000	*	0.000	*
4	The objective of financial statements is to assist investors in making economic decisions - whether to buy, hold or sell their investment.	0.000	*	0.000	*
5	The objective of financial statements is to present a true and fair view of a company's financial performance and financial position for a reporting period.	0.000	*	0.000	*
6	Financial statements show whether a company is well managed.	0.000	*	0.000	*
7	Financial statements show the efficiency with which a company is being run.	0.313		0.000	*
8	Financial statements portray management's ability to economically use the resources entrusted to it.	0.666		0.000	*
9	The objective of financial statements is to present a picture of the company's short-term performance.	0.000	*	0.000	*
10	Financial statements provide information that enables investors to measure a company's long-term performance.	0.000	*	0.000	*
11	The objective of preparing financial statements is to compute and present the profit earned by a company during a reporting period.	0.000	*	0.000	*
12	The audit of financial statements by an independent auditor ensures that financial statements are free of material errors, frauds or irregularities.	0.000	*	0.000	*
13	The change in focus from the income statement (emphasising income and expenditure) to the balance sheet (emphasising the assets and liability approach) provides more relevant information to investors.	0.000	*	0.000	*
14	The use of fair values and mark-to-market accounting provides more relevant information than historical cost accounts.	0.000	*	0.000	*
15	Financial statements provide assurance to shareholders that a company has complied with the applicable rules and regulations.	0.000	*	0.000	*
16	The objective of financial statements is to ensure the accuracy and legitimacy of accounting records.	0.000	*	0.000	*
17	Financial statements enable shareholders to assess management's stewardship of the company's assets.	0.000	*	0.000	*
18	Financial statements show whether a company is a good investment or not.	0.255		0.000	*
19	Financial statements show whether a company is a going concern.	0.000	*	0.000	*
20	Financial statements show whether a company has a sound internal control structure.	0.000	*	0.000	*
21	The inclusion of an audit report enhances the credibility of a company's financial statements.	0.000	*	0.000	*
22	The inclusion of other reports (e.g. chairman's statement) provides useful information to the shareholders.	0.000	*	0.000	*
23	Financial statements present an accurate and complete picture of a company's financial performance and financial position.	0.000	*	0.000	*
24	An exercise of judgement is required in the preparation of financial statements.	0.000	*	0.000	*
25	Financial statements can achieve various objectives with the same set of figures.	0.000	*	0.000	*
26	An unqualified audit report implies that the financial statements are free from fraud.	0.014	*	0.014	*
27	The primary use of financial statements is for tax purposes.	0.000	*	0.000	*
28	The primary use of financial statements is for use by bankers and providers of finance.	0.023	*	0.023	*

* significantly different from neutral value at $p < 0.05$

Table 5.17: One-sample t-test: Section 1 - The objective of financial statements

The responses given to the statements that were included in Section 1 of the questionnaire have been grouped by theme and are presented under the following sub-headings:

(i) *Internal Controls*

A statistically significant difference was noted in the statement focusing on whether financial statements are a reflection of the soundness of the company's internal control system (Statement 20 "*Financial statements show whether a company has a sound internal control structure*"). Internal controls are the responsibility of those charged with governance and it is those charged with governance who are responsible for preparing financial statements. Accordingly, this statement sought to elicit the respondents' views on whether financial statements show that a company has a good system of internal controls. Auditors were clearly in disagreement with this statement, whereas shareholders were more inclined to agree. In fact, 53.9% of shareholders agreed or strongly agreed with this statement and the remaining shareholders expressed neutral views. The difference in the respondents' views has resulted in the largest effect size ($r=0.614$) in this section of the questionnaire. The sharp contrast in the views expressed is also evident from two comments that were included in the open ended question at the end of the questionnaire. One auditor commented that:

"Financial statements will give a true and fair view of the Company's financial position and performance during the year; however it does not necessarily portray how well the Company is being managed and neither it gives indication of fraud, or the effectiveness of internal controls."

In sharp contrast to this, one shareholder remarked that:

"The financial results of a company in a year are a reflection of two factors - management decisions and internal controls. That is why we need financial statements – to show us the results of management and the appropriateness of internal controls. But auditors need to do their work, and ensure that there are no frauds. Why would we need financial statements and the audit function otherwise?"

This therefore highlights the different perceptions on the subject matter between the two respondent groups.

(ii) *Management's performance and stewardship*

Statistically significant differences were also noted in the statements focusing on the use of financial statements as a gauge of management's performance and its stewardship. Statement 6 (*"Financial statements show whether a company is well managed"*) focused on the ability of financial statements to show how "well managed" a company is. Shareholders tended to agree more with this statement than the auditors did. In fact, 68.1% of shareholders agreed or strongly agreed with this statement. On the other hand, auditors expressed mixed views on the ability of financial statements to be used as an indicator of the proper management of the company – 46.1% selected the "neutral" option, 33.3% disagreed / strongly disagreed with the statement while 20.6% agreed / strongly agreed with it. This was another statement with a high effect size ($r=0.507$) and with different medians between the two respondent groups (the median score for auditors fell in the "neutral" category while that for shareholders was in the "disagree" category). Similar results were obtained in other statements of the questionnaire dealing with different aspects of managing the company's affairs, namely the "efficiency" with which a company is being run (Statement 7 *"Financial statements show the efficiency with which a company is being run"*) and the "economy" with which a company is being run (Statement 8 *"Financial statements portray management's ability to economically use the resources entrusted to it"*). Auditors generally expressed neutral views on these two aspects, while shareholders were more inclined to consider financial statements as being a reflection of the efficiency and effectiveness with which the company's resources have been utilised. Again, statistically significant differences were identified in the responses given with large size effects ($r=0.442$ and $r=0.394$ respectively) for these two statements. Shareholders were therefore more inclined to consider financial statements as being a tool that can give insights on three measures of managerial performance, namely effectiveness, efficiency and economy, albeit that their responses were not definitive in the agree categories. The responses from auditors, however, suggested a different view. One auditor commented in the open-ended question that:

"We cannot reasonably expect financial statements to deal with effectiveness, efficiency and economy. A statutory audit is a financial audit, not a value-for-money one. If shareholders want a value-for-money audit, then they should commission one!"

The two respondent groups expressed mixed views on the ability of financial statements to measure both the company's short-term (Statement 9 "*The objective of financial statements is to present a picture of the company's short-term performance*") and long-term performance (Statement 10 "*Financial statements provide information that enables investors to measure a company's long-term performance*"). In the case of the latter two statements, no statistically significant differences were identified in the responses given, with responses generally falling in the "neutral" category. While mixed views were expressed on the short term versus long term focus of financial statements, both respondent groups were distinctly in agreement on the "historical focus" of financial statements. Statement 2 ("*Financial statements are useful to enable shareholders to monitor the past performance of a company*") was agreed to by both respondent groups, with the median responses for both groups falling in the "Agree" category. However, auditors were far more supportive of this statement than shareholders and a statistically significant difference was again identified. In fact, it was only 0.8% of auditors that disagreed with this statement; all other responses fell in the agree / strongly agree category. One interesting comment by an auditor was the following:

"We need to go back to basics. Accounting is concerned with reporting on past events, not future ones! We are not fortune tellers".

Responses to Statement 3 ("*Financial statements enable shareholders to predict future performance and future cash flows of a company*") resulted in responses have a statistically significant difference with an effect size r of 0.381. Auditors and shareholders expressed mixed views on the predictive capability of financial statements, albeit that auditors were generally more in disagreement with this statement than shareholders were. In fact, 34.6% of auditors disagreed / strongly disagreed with this statement and 56% expressed neutral views. In the case of shareholders, 65.8% expressed neutral views and 27.6% agreed / strongly agreed with this statement. The results of the responses to Statements 2 and 3 therefore show that financial statements are perceived as having more of a historical perspective, particularly by the auditors.

The responses given to Statement 17 ("*Financial statements enable shareholders to assess management's stewardship of the company's assets*") show that auditors and

shareholders generally agreed that financial statements could be used as an assessment of management's stewardship. 60.9% and 60.2% of auditors and shareholders respectively agreed / strongly agreed with this statement, with the other responses falling in the neutral category. No statistical significant difference was noted in the responses to this statement.

(iii) Decision-making

The economic decision-making dimension of financial statements was the subject of Statement 4 (*"The objective of financial statements is to assist investors in making economic decisions – whether to buy, hold or sell their investment"*). A statistically significant difference was noted in the responses given by the two respondent groups. Shareholders (83.1%) expressed a higher level of agreement with this statement than auditors (60.1%). The decision-making use of financial statements by shareholders was also shown in their responses to Statement 11 (*"The objective of preparing financial statements is to compute and present the profit earned by a company during a reporting period"*) which focused on the computation and presentation of the profit earned by the entity in a financial year. Profitability is one important factor that investors consider in their investment decisions, and in fact, shareholders expressed their agreement that the objective of financial statements is to measure profitability. Auditors were also in agreement with this statement, with 53.9% of responses falling in the agree / strongly agree category. However, as many as 83.5% of the shareholders agreed / strongly agreed with the statement, and in fact, a statistically significant difference was again noted.

The use of financial statements as an indicator of whether a company is "a good investment or not" was the subject of Statement 18 (*"Financial statements show whether a company is a good investment or not"*). Shareholders were more in agreement with this statement than auditors, and in fact, different medians were recorded between the two respondent groups. Auditors expressed mixed views when answering this statement, with responses varying from "strongly agree" to "strongly disagree". Shareholders (70.8%) were more in agreement with this statement than auditors (34.1%), indicating that they considered financial statements as being relevant to their investment decisions. Statistically significant differences were again noted with a significant effect ($r=0.448$).

Another statement in this section (Statement 1 “*The objective of financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity*”) focused on the use of financial statements not just for the decision-making requirements of shareholders, but also for the purpose of other decisions taken by lenders and other creditors providing resources to the entity. This statement has reproduced the IASB’s current objective of financial statements in order to elicit the respondents’ view on this primary objective. Both respondent groups were generally in agreement with this statement, with auditors showing a higher degree of agreement than shareholders. This resulted in a statistically significant difference in the responses given, with a medium effect size of $r=0.234$. When asked whether the “primary use” of financial statements is for use by bankers and providers of finance (Statement 28 “*The primary use of financial statements is for use by bankers and providers of finance*”), auditors expressed their disagreement while shareholders expressed neutral views. Tax was also not identified as a primary purpose for preparing financial statements (Statement 27 “*The primary use of financial statements is for tax purposes*”). Auditors disagreed with this statement, while shareholders expressed mixed views on this aspect. Statistically significant differences were noted in the responses given for both Statement 28 and Statement 27.

(iv) A true and fair view

The use of “judgement” in the preparation of financial statements (Statement 24 “*An exercise of judgement is required in the preparation of financial statements*”) was another aspect that resulted in a statistically significant difference with a large effect of $r=0.446$ in the responses received. Auditors, being more familiar with the need to use judgments or estimation in the preparation of financial statements, tended to agree with this statement. In fact, 76.5% of auditors agreed / strongly agreed with this statement. On the other hand, shareholders expressed mixed views on the need for judgement to be used in the preparation of a set of financial statements of an entity, with 55% of shareholders choosing the neutral option. Different medians were recorded between the two respondent groups.

These findings can also be linked to the concept of “truth and fairness” (Statement 5 “*The objective of financial statements is to present a true and fair view of a company’s financial performance and financial position for a reporting period*”) that is so frequently referred to by auditors. One of the inherent limitations of the audit process is the nature of financial reporting that demands the use of judgments and estimation. Accordingly, auditors are precluded from giving absolute assurance on financial statements but instead issue an opinion on whether the financial statements give “a true and fair view” or whether they “present fairly, in all material respects” the state of affairs of the entity. The concept of truth and fairness, being one of the fundamental concepts of the subject of auditing, could be readily related to by auditors in their responses. In fact, auditors were in agreement with this statement, with all auditor responses falling either within the “agree” or “strongly agree” category. The two respondent groups were distinctly in agreement with regard to the importance of the concept of truth and fairness. Both groups agreed that the objective of financial statements is to present a true and fair view of the financial performance and financial position of an entity for a reporting period. However, there was a statistically significant difference in the responses given whereby auditors expressed a significantly higher level of agreement with this statement than shareholders did.

The responses given to Statement 5 were corroborated by the similar responses given to Statement 12 (“*The audit of financial statements by an independent auditor ensures that financial statements are free of material errors, frauds or irregularities*”). Although both auditors and shareholders were again in agreement with this statement, a statistically significant difference was still recorded.

While Statement 5 focused on the concept of “truth and fairness”, in contrast to this, Statement 23 (“*Financial statements present an accurate and complete picture of a company’s financial performance and financial position*”) referred to financial statements as presenting an “accurate” and “complete” picture of a company’s financial position. Auditors expressed mixed views on this statement. The majority of responses (51%) fell in the neutral category. On the other hand, shareholders were more inclined to agree with this statement, considering financial statements as an “accurate”

representation of the company's state of affairs. In fact, 66.2% of shareholders agreed / strongly agreed with this statement. The "accuracy" aspect was also referred to in Statement 16 (*"The objective of financial statements is to ensure the accuracy and legitimacy of accounting records"*). The responses to this statement were similar to those of the aforementioned Statement 23, with shareholders expressing a higher degree of agreement with this statement than auditors did. A statistically significant difference was noted for this statement as well.

The auditor's opinion on the truth and fairness of financial statements is included in the auditor's report, and Statement 21 (*"The inclusion of an audit report enhances the credibility of a company's financial statements"*) focused on whether the inclusion of this report with the financial statements prepared by management adds credibility to the said financial statements. Both respondents agreed with this statement. However, the auditor's agreement to this statement was higher than that of shareholders. The findings indicate that auditors consider that their report adds credibility to a higher extent than shareholders do, and in fact, yet another statistically significant difference was noted. The importance of the audit function was therefore duly acknowledged by both respondent groups, albeit to a different level.

The added credibility or "assurance" provided by an audit of financial statements was also referred to in relation to audited financial statements providing assurance that the company has properly complied with the applicable rules and regulations (Statement 15 *"Financial statements provide assurance to shareholders that a company has complied with the applicable rules and regulations"*). Auditors were more in agreement with this statement than shareholders were, and another statistically significant difference was identified for this statement.

Both respondent groups, however, agreed that including other reports apart from the auditor's report in the annual report prepared by a company provides useful information to the shareholders (Statement 22 *"The inclusion of other reports (e.g. Chairman's statement) provides useful information to the shareholders"*). Both respondent groups were generally in agreement with this statement, albeit that auditors expressed a higher

degree of agreement and a statistically significant difference was identified in the responses given by the two respondent groups.

Statement 26 (*“An unqualified audit report implies that the financial statements are free from fraud”*) focused on the element of “fraud” and whether an unqualified audit report implied that financial statements were free from fraud, whether of a material or immaterial nature. Auditors were generally in disagreement with this statement. In fact, the majority of auditors (54.7%) disagreed / strongly disagreed with this statement. Surprisingly, a sizeable percentage of auditors (39.1%) selected the “Not sure” option. Shareholders expressed mixed views ranging at the two extreme ends of the Likert scale. 38.6% of shareholders disagreed / strongly disagreed with this statement while 28.3% agreed / strongly agreed with it. The remaining 33.1% of shareholders were unsure on how to reply to this statement.

(v) Going concern

The ability of financial statements to show the going concern status of an entity (Statement 19 *“Financial statements show whether a company is a going concern”*) was another statement that witnessed a statistically significant difference in the responses given. Both respondent groups agreed that financial statements could be used to assess the going concern of an entity, with auditors showing a higher degree of support to this statement than shareholders did. In fact, 79% of the auditors agreed / strongly agreed with this statement; on the other hand, 66.5% of shareholders agreed / strongly agreed that financial statements showed the going concern status of the entity and 32.7% expressed neutral views.

(vi) Fair values

The use of fair values and mark-to-market accounting was the subject of Statement 14 (*“The use of fair values and mark-to-market accounting provides more relevant information than historical cost accounts”*). 66.6% of the responses from auditors indicated that they agreed / strongly agreed that the use of fair values enhances the

relevance of information provided, while shareholders (55.1%) expressed a neutral view on this matter. A statistically significant difference was noted in the responses given. The use of fair values as a basis for the valuation of assets and liabilities was also referred to in Statement 13 (*“The change in focus from the income statement [emphasizing income and expenditure] to the balance sheet [emphasizing the assets and liability approach] provides more relevant information to investors”*). 53.9% of auditors agreed / strongly agreed on this point, while 42% expressed a neutral view; on the other hand, 50.8% of shareholders agreed / disagreed with this statement, while 47.3% expressed neutral views. No statistically significant difference was noted for this statement.

Summary

The responses given to the statements included in Section 1 of the questionnaire indicated that the two surveyed respondent groups, namely auditors and shareholders, shared different views on the objective of financial statements.

Auditors and shareholders were in agreement on the stewardship function of financial statements. Both respondent groups agreed that financial statements have a historical focus as opposed to a future oriented one. According to the surveyed auditors, the objective of financial statements was to present a true and fair view of the entity's financial performance and financial position for a reporting period. However, shareholders believed that financial statements are meant to show whether a company is well-managed, therefore indicating how efficient, effective and economical management was in the use of the entity's resources. In this respect, financial statements were perceived by shareholders as presenting an accurate and complete picture of the company's state of affairs, including whether the entity has a sound internal control structure.

Shareholders also considered financial statements useful for decision-making purposes, providing them with information on whether the investee company was a good investment. Auditors, whilst agreeing on decision-making as an objective, were more inclined to restrict their views to the objective of financial statements being that of

providing information for decision-making purposes to the providers of finance, in line with the standard-setters present conceptual framework. Respondents also believed that financial statements were relevant to provide information of whether an entity is a going concern.

Financial statements were therefore considered by the respondents groups as being able to satisfy different objectives, albeit that the surveyed respondents expressed different views on what these objectives are. Auditors and shareholders agreed with Statement 25 (*“Financial statements can achieve various objectives with the same set of figures”*), albeit that a statistical significant difference was again noted. In fact, 74.9% of the surveyed auditors and 51.9% of the surveyed shareholders agreed / strongly agreed that financial statements could be used to fulfill different objectives with the same set of figures.

5.3.4.2 THE UNDERSTANDABILITY OF FINANCIAL STATEMENTS

Table 5.18 presents the findings with respect to the statements contained in Section 2 of the questionnaire. The findings are presented in a similar format to the previous section.

Table 5.18 accordingly shows the mean rating scores, medians, minimum and maximum values, and the results of the t-test and Mann Whitney U-test for the two respondent groups and the effect size test.

		AUDITORS		SHAREHOLDERS		t-test p-value	Mann- Whitney p-value	Effect size r (Mann- Whitney)
		Mean Rating Score	Median (Min - Max)	Mean Rating Score	Median (Min - Max)			
SECTION 2: THE UNDERSTANDABILITY OF FINANCIAL STATEMENTS								
47	A simple two or three page report with key information would suffice.	2.70	3 (1 - 5)	3.77	4 (1 - 5)	0.000	0.000	* 0.551
29	Audited financial statements are the most important communications link between a company and its shareholders.	3.22	3 (1 - 5)	4.12	4 (1 - 5)	0.000	0.000	* 0.518
43	Financial statements disclosures are too lengthy and complex to read.	3.65	4 (2 - 5)	4.23	4 (1 - 5)	0.000	0.000	* 0.488
50	Financial statements appropriately communicate the limitations of financial reporting to shareholders.	2.70	3 (1 - 4)	3.47	3 (1 - 5)	0.000	0.000	* 0.459
46	Shareholders are able to understand the information contained in financial statements but find it irrelevant or of little use with regards to investment decisions.	2.71	3 (1 - 4)	3.28	3 (1 - 5)	0.000	0.000	* 0.404
33	Financial statements are too complex to be understood.	3.28	3 (2 - 5)	3.88	4 (2 - 5)	0.000	0.000	* 0.380
48	Terms worded in Maltese would facilitate the user's understanding of financial statements.	2.30	2 (1 - 5)	3.06	3 (1 - 5)	0.000	0.000	* 0.375
36	Educating investors would help investors better understand the scope and limitations of financial statements.	3.98	4 (2 - 5)	4.46	4 (2 - 5)	0.000	0.000	* 0.352
37	The inclusion of key performance indicators makes financial reports more relevant to shareholders.	3.81	4 (2 - 5)	4.29	4 (2 - 5)	0.000	0.000	* 0.337
35	The use of graphs in financial statements would make financial statements more understandable.	3.60	4 (1 - 5)	4.07	4 (1 - 5)	0.000	0.000	* 0.333
42	Educating the shareholder to read financial statements would enable him/her to understand the message of financial statements and make more informed investment decisions.	4.00	4 (2 - 5)	4.29	4 (2 - 5)	0.000	0.000	* 0.229
38	A private individual shareholder is at a disadvantage in understanding financial statements when compared to institutional shareholders.	3.84	4 (1 - 5)	4.18	4 (1 - 5)	0.000	0.000	* 0.228
31	The company's financial statements are understood by shareholders.	2.70	3 (1 - 4)	2.30	2 (1 - 5)	0.000	0.000	* 0.221
34	The message of financial statements is 'lost' in the clutter of lengthy disclosures and regulatory terminology.	3.73	4 (2 - 5)	3.97	4 (1 - 5)	0.000	0.000	* 0.193
40	Accounting terminology included in financial statements is well understood by shareholders.	2.43	2 (1 - 4)	2.11	2 (1 - 5)	0.000	0.000	* 0.192
41	A higher degree of narrative or descriptive reporting assists shareholders in understanding financial statements.	3.12	3 (1 - 4)	3.44	3 (1 - 5)	0.000	0.000	* 0.190
49	Including a glossary of technical terms in financial statements would enable shareholders to understand the message of financial statements.	3.42	3 (1 - 5)	3.68	4 (1 - 5)	0.000	0.000	* 0.159
45	The message of financial statements should be clearly explained at the Annual General Meeting of the company.	4.13	4 (3 - 5)	4.29	4 (3 - 5)	0.000	0.001	* 0.156
44	The Maltese investor is financially literate enough to understand financial statements.	2.30	2 (1 - 4)	2.13	2 (1 - 4)	0.016	0.006	* 0.124
30	The company's financial statements are read by shareholders.	3.02	3 (1 - 5)	2.92	3 (1 - 5)	0.114	0.096	0.075
39	The reported accounting information contained in financial statements presents in a clear manner its economic message to the shareholder.	3.10	3 (1 - 5)	3.19	3 (1 - 4)	0.194	0.174	0.061
32	The present format and content of financial statements is adequate to meet investors' requirements.	3.02	3 (1 - 5)	3.04	3 (1 - 5)	0.800	0.796	0.012

* significantly different between auditors and shareholders at $p \leq 0.05$

Table 5.18: Section 2 – The understandability of financial statements

[Note: The findings are presented in descending order (largest to smallest) based on the result of the effect size formula (r) for the Mann Whitney U-test]

Table 5.18 shows that out of the twenty-two statements included in Section 2 of the questionnaire, nineteen statements had statistically significant responses between auditors and shareholders at $p \leq 0.05$. It is also important to note that, in a similar manner to Section 1 of the questionnaire, the p-values for all the said nineteen statements are also well below the 0.05 level, generally at $p < 0.001$. The effect size for the Mann Whitney test has also resulted in ten statements having a large effect and another nine statements having a medium effect. It was only three statements that resulted in a small effect when using Cohen's (1988) guidelines for effect size r .

The one-sample t-test was again used to test whether the mean answer received is significantly higher or lower than the neutral value of three. The results of this test are shown in Table 5.19. This test confirmed that conclusions can be drawn from the answers received for most of the responses given by auditors and shareholders. In fact, the responses received were statistically at $p \leq 0.05$ from the neutral value for all the responses given by auditors and shareholders, except for two statements in the case of auditors (Statement 30 and 32) and two statements for shareholders (Statement 32 and 48).

		AUDITORS	SHAREHOLDERS		
		p value	p value		
29	Audited financial statements are the most important communications link between a company and its shareholders.	0.000	*	0.000	*
30	The company's financial statements are read by shareholders.	0.603		0.000	*
31	The company's financial statements are understood by shareholders.	0.000	*	0.000	*
32	The present format and content of financial statements is adequate to meet investors' requirements.	0.698		0.452	
33	Financial statements are too complex to be understood.	0.000	*	0.000	*
34	The message of financial statements is 'lost' in the clutter of lengthy disclosures and regulatory terminology.	0.000	*	0.000	*
35	The use of graphs in financial statements would make financial statements more understandable.	0.000	*	0.000	*
36	Educating investors would help investors better understand the scope and limitations of financial statements.	0.000	*	0.000	*
37	The inclusion of key performance indicators makes financial reports more relevant to shareholders.	0.000	*	0.000	*
38	A private individual shareholder is at a disadvantage in understanding financial statements when compared to institutional shareholders.	0.000	*	0.000	*
39	The reported accounting information contained in financial statements presents in a clear manner its economic message to the shareholder.	0.000	*	0.000	*
40	Accounting terminology included in financial statements is well understood by shareholders.	0.000	*	0.000	*
41	A higher degree of narrative or descriptive reporting assists shareholders in understanding financial statements.	0.000	*	0.000	*
42	Educating the shareholder to read financial statements would enable him/her to understand the message of financial statements and make more informed investment decisions.	0.000	*	0.000	*
43	Financial statements disclosures are too lengthy and complex to read.	0.000	*	0.000	*
44	The Maltese investor is financially literate enough to understand financial statements.	0.000	*	0.000	*
45	The message of financial statements should be clearly explained at the Annual General Meeting of the company.	0.000	*	0.000	*
46	Shareholders are able to understand the information contained in financial statements but find it irrelevant or of little use with regards to investment decisions.	0.000	*	0.000	*
47	A simple two or three page report with key information would suffice.	0.000	*	0.000	*
48	Terms worded in Maltese would facilitate the user's understanding of financial statements.	0.000	*	0.305	
49	Including a glossary of technical terms in financial statements would enable shareholders to understand the message of financial statements.	0.000	*	0.000	*
50	Financial statements appropriately communicate the limitations of financial reporting to shareholders.	0.000	*	0.000	*

* significantly different from neutral value at $p \leq 0.05$

Table 5.19: One-sample t-test: Section 2 – The understandability of financial statements

The responses given to the statements that were included in Section 2 of the questionnaire have been grouped by theme and are presented under the following sub-headings:

(i) *Complexity of financial statements*

A statistically significant difference was noted in the responses of auditors and shareholders to Statement 47 ("A simple two or three page report with key information would suffice"). This difference in the respondents' views has resulted in the largest effect size ($r=0.551$) in this section of the questionnaire. Auditors have expressed a mixed view on this statement: 42.8% of respondents selected the disagree / strongly disagree category,

18.5% of responses opted for the agree / strongly agree category and 38.7% selected the neutral option. On the other hand, 68.4% of the surveyed shareholders were far more receptive to “simple” information that focuses on the “key information”. In fact, an overwhelming 94.5% of the survey shareholders expressed their agreement / strong agreement to Statement 37 (*“The inclusion of key performance indicators makes financial reports more relevant to shareholders”*) which also focuses on the inclusion of “key performance indicators” in financial reports. Both respondent groups agreed with this statement, with shareholders expressing a higher degree of agreement with this statement than auditors. This was another statement where a statistically significant difference was identified. One shareholder commented in the last open-ended question as follows:

“Financial statements have become too long and difficult for me. Sometimes, I cannot even decipher what the profit figure isthere are so many columns and numbers! Not to mention the long pages of narrative! We want key messages being communicated to us, in a clear, concise manner....in a way that the non-accountant can understand”.

A similar view was echoed by one auditor who included this commentary in his response:

“With regards to the company's financial statements, shareholders are supposed to read the financial statements but unfortunately they do not do so for various reasons, mainly because of time since they are quite long and also since it depends on the type of investor - if it is an investor who has studied something or has been educated in something related to finance, he/she will be able to understand a majority of the wording from the financial statements, but if it is someone who is illiterate or else has specialised in other areas not related to finance for eg. a doctor he/she will not probably be able to understand the technical wording. In my own opinion, providing a more descriptive/narrative financial statements does not assist shareholders in understanding financial statements but due to timing they might see it more as a waste of time to read all that material. On a last note, financial statements need to be clear and in simple wording for the common investor to be able to understand them”.

The issue of the complexity of financial statements is prevalent in a number of statements included in this part of the questionnaire. Thus, for example, the majority of shareholders (74.3%) agreed / strongly agreed that financial statements were too complex to be

understood (Statement 33 “*Financial statements are too complex to be understood*”). Auditors expressed mixed views on this statement and a statistically significant difference between the two groups was noted. Both auditors and shareholders agreed that disclosures included in financial statements were too lengthy and complex to read, albeit that shareholders expressed a significantly higher level of agreement with this statement than auditors did (Statement 43 “*Financial statements disclosures are too lengthy and complex to read*”). A large effect size r of 0.459 was noted in this statement. The responses to Statement 34 (“*The message of financial statements is ‘lost’ in the clutter of lengthy disclosures and regulatory terminology*”) re-confirmed the views of the respondents on the volumes of information being included in financial statements – both auditors and shareholders agreed with this statement, with shareholders holding stronger views on this when compared to auditors. The difference in the responses was in fact statistically significant. One interesting remark written by a shareholder was the following:

“The preparation of financial statements has become a compliance matter. Boxes need to be ticked, and the more information is included, the better is the chance that shareholders will get lost in numbers and words! Companies are just communicating more, not better”.

The complexity of financial statements places the individual shareholder at a disadvantage when compared to the institutional investor who may have a more solid technical base to interpret financial statements. This was the subject of Statement 38 (“*A private individual shareholder is at a disadvantage in understanding financial statements when compared to institutional shareholders*”). Both respondent groups agreed with this statement, albeit to a different extent – shareholders expressed stronger views on this statement (85.7% of responses were in the agree / strongly agree category), and the difference in the responses between the two groups was statistically significant.

(ii) Communication

Shareholders perceived financial statements as being the “most important communications link” in the financial reporting process (Statement 29 “*Audited financial*”).

statements are the most important communications link between a company and its shareholders". In fact, an overwhelming 87% of shareholders agreed / strongly agreed with this statement. On the other hand, auditors expressed mixed views on this statement. In fact, the medians of the two respondent groups were different and there was also a statistically significant difference with a large effect size r of 0.518. The result to this statement implies that auditors believe that there may be other information that constitutes the most important communications link. In fact, one auditor commented in the last question that:

"The directors should communicate effectively what they have achieved and where they want to take the company – this is why a chairman's report and a directors' report is included. I think that these two reports are the most important communications link with shareholders. Auditors are not meant to step in the directors' shoes".

In sharp contrast to this, one shareholder commented as follows:

"I work in the media. I have learnt that messages need to be clear and concise. Financial statements and the audit report are a way of communicating information....but unfortunately, they are neither clear nor concise".

In addition, both auditors and shareholders expressed mixed views on Statement 50 (*"Financial statements appropriately communicate the limitations of financial reporting to shareholders"*). Both auditors and shareholders had different views on this statement, generally selecting the "neutral" option. A statistically significant difference was again noted here.

(iii) Understandability

A number of statements in this Section of the questionnaire were included to assess the respondents' perception on the understandability of financial statements.

Statement 30 (*"The company's financial statements are read by shareholders"*) was one statement where no statistical difference was identified in the responses received. Both respondent groups expressed neutral views on whether financial statements were actually

read by shareholders. In fact, 50.6% of the surveyed auditors and 49.2% of the surveyed shareholders selected the “neutral” option. Statement 31 (*“The company’s financial statements are understood by shareholders”*) used the same wording as the aforementioned Statement 30 but replaced the word “read” with “understood”. The change in the meaning of this statement was in fact well noted by the respondents – whilst shareholders were neutral on the “reading” element, they have expressed their disagreement on Statement 31 relating to the actual “understanding” of the financial statements. 57.9% of the surveyed shareholders believed that financial statements were not understood by shareholders. Likewise, auditors disagreed with this statement, albeit to a lower degree. In fact, 41.9% of the auditors selected the disagree / strongly agree option. Statistically significant differences were noted for both statements. One shareholder commented as follows:

“Am I expected to read all those pages? And, am I expected to understand them? Please, cut the clutter and tell me what the key message is....in simple terms”.

Auditors and shareholders expressed mixed views on the relevance of financial statements to investment decisions (Statement 46 *“Shareholders are able to understand the information contained in financial statements but find it irrelevant or of little use with regards to investment decisions”*). Both respondent groups agreed with the statement that the Annual General Meeting may represent the occasion where the message of financial statements can be explained to shareholders (Statement 45 *“The message of financial statements should be clearly explained at the Annual General Meeting of the company”*). Shareholders (97.6%) were more supportive of this statement than auditors (93.4%), and in fact, a statistically significant difference was noted in the responses given.

The issue with the understandability of financial statements did not appear to be one related to the language (English) in which financial statements are prepared. Auditors have expressed their disagreement that preparing financial statements in Maltese would facilitate the understandability of financial statements. Shareholders were likewise not too keen on this matter and generally expressed neutral views on this statement (Statement 48 *“Terms worded in Maltese would facilitate the user’s understanding of financial statements”*). A statistical significant difference with a relatively large effect size r

(0.375) was identified in the responses given. One shareholder commented on the language aspect as follows:

*“It is not a question of language, Maltese versus English.
It is a question of using language that is understandable.
To me, financial statements are sometimes like Chinese”.*

On the other hand, respondents were more inclined to agree with the statement suggesting the inclusion of graphs in financial reports (Statement 35 *“The use of graphs in financial statements would make financial statements more understandable”*). Both auditors and shareholders agreed with this statement, albeit that shareholders were more receptive to this suggestion. In fact, 81.8% of shareholders and 63.4% of auditors agreed / strongly agreed with this statement. A statistically significant difference in the responses given was noted in this regard. Respondents have shown a preference for graphical illustration when compared to the inclusion of more narrative or descriptive reporting in financial statements (Statement 41 *“A higher degree of narrative or descriptive reporting assists shareholders in understanding financial statements”*). Both auditors and shareholders have expressed neutral views on the inclusion of further narrative reporting in financial statements.

(iv) Education

The educational aspect also featured in a number of statements that have been included in this section of the questionnaire. Both respondent groups agreed that the Maltese investor does not have a sufficiently strong financial background to understand the message of financial statements (Statement 44 *“The Maltese investor is financially literate enough to understand financial statements”*). Auditors have expressed a higher degree of disagreement with this statement than shareholders. On the other hand, the responses given by shareholders are indicative of the willingness of shareholders to learn more on the subject in order to be able to understand the scope and limitations of financial statements (Statement 36 *“Educating investors would help investors better understand the scope and limitations of financial statements”*). Both auditors and shareholders agreed with this statement, but shareholders showed a higher level of agreement. In fact,

an overwhelming 98.8% of the surveyed shareholders agreed / strongly agreed with this statement. Similar results were obtained for Statement 42 (*“Educating the shareholder to read financial statements would enable him/her to understand the message of financial statements and make more informed investment decisions”*). There is therefore consensus on the importance of improving the financial literacy of investors; however, shareholders expressed stronger views on this subject than auditors.

Improving the financial literacy of shareholders would also help in understanding technical terms included in financial statements. Both auditors and shareholders agreed that certain technical jargon included in financial statements was not understood by shareholders (Statement 40 *“Accounting terminology included in financial statements is well understood by shareholders”*). A statistically significant difference was noted in the responses given to this statement, with auditors expressing a higher level of disagreement than shareholders did. Auditors expressed mixed views while shareholders were generally in agreement with the suggestion of including a glossary of technical terms (Statement 49 *“Including a glossary of technical terms in financial statements would enable shareholders to understand the message of financial statements”*). This was another statement where a statistical significant difference was identified.

Summary

The responses given to the statements included in Section 2 of the questionnaire indicated that the two surveyed respondent groups are in agreement on a number of aspects related to the understandability of financial statements. However, given the number of significant differences noted, the extent of agreement or disagreement varies, therefore resulting in a gap between the auditors and shareholders views.

Shareholders expressed strong views on the complexity of financial statements, agreeing that financial statements were too long and that they therefore got lost in the information included therein. In fact, they agreed that financial statements were not understood by shareholders and that the reason was not attributable to a language issue (Maltese versus English). Shareholders have therefore advocated in favour of simpler reports that include

key messages and key performance indicators, possibly in a graphical format rather than through additional narrative. Auditors agreed with these points, albeit in all cases, to a lower extent than shareholders did.

The understandability of financial statements for shareholders was a critical issue because shareholders considered financial statements as being the most important communications link with them. As a result, shareholders agreed that financial statements needed to be explained to them, given the low level of financial literacy that shareholders had. One venue where financial statements could be explained in detail was the company's Annual General Meeting. Shareholders also expressed their wish to learn and be educated on the subject so as to be in a better position to understand financial statements. The responses given by auditors were again similar to those of shareholders, but again, the extent of agreement or disagreement was less acute than that expressed by shareholders.

5.3.4.3 THE USE OF FINANCIAL STATEMENTS

Question 51 in the questionnaire required participants to rank in order of importance the use of financial statements.

The following six uses were listed for participants: decision making, predicting future cash flows, assessing stewardship, tax purposes, communicating financial information, valuation purposes.

Participants were advised that “1” denoted the factor that is most significant whereas “6” denoted the factor that was least significant. Both auditors and shareholders were in agreement in ranking “communicating financial information” as being the most important use of financial statements. At the other extreme, auditors considered the “prediction of future cash flows” as being the least important factor, while shareholders considered “tax purposes” as the least important factor.

Table 5.20 presents the mean responses given to this question by auditors and shareholders and it also presents the results of the Kruskal Wallis test for comparing the mean responses between the groups.

The results are presented in order of importance (from the most important use to the least important one) based on the average means of the two groups.

	Auditors	Shareholders	
Use of financial statements	Mean	Mean	p value
Communicating financial information	1.84	2.38	0.000 *
Valuation purposes	3.84	2.89	0.000 *
Decision making	3.22	2.94	0.013 *
Assessing stewardship	3.91	3.98	0.109
Predicting future cash flows	5.06	4.07	0.000 *
Tax purposes	3.12	4.17	0.000 *

* significantly different between auditors and shareholders at $p \leq 0.05$

Table 5.20 – Ranking the use of financial statements

It is worth noting that out of the six statements, five statements have shown statistically significant differences (at $p < 0.001$) between the mean rating scores of the two groups for the different statements.

Both auditors and shareholders have ranked the communication of financial information as being the most important use of financial statements. Although there is agreement on the importance of communication, shareholders have attributed a higher degree of importance to the communicative function of financial statements than auditors did. According to the auditors, the least important use of financial statements was to predict future cash flows, while according to shareholders, financial statements were least important for tax purposes.

5.3.4.4 REGRESSION ANALYSIS

This Section presents the results of the regression analysis performed on the responses received from auditors and shareholders.

The major limitation of the t-test and Mann Whitney U-test is that they investigate solely the relationship between a dependent variable and a single categorical variable. However, the objective of many research studies is to estimate collectively the impact of the predictors on the dependent variable. Regression analysis shall therefore be used in order to predict the values of a dependent variable given the values of one or more independent variables (Saunders, 2012). It is a way of statistically determining those variables that do indeed have an impact on the result. To use this model, it is assumed that the participants perceive scale spacing when rating the statements.

Five statements included in the questionnaire were selected by the researcher for the purpose of the regression analysis. The selected statements were considered by the researcher to be critical in addressing the research objectives of the study and also informing the research questions of the study. These five statements focus on the objective of financial statements (decision-making, monitoring past performance, predicting future performance) and the understandability of financial statements (including the communication of the limitations of financial statements).

For the first statement being analysed (Statement 1), the relevant tables are followed by a detailed explanation of how the results are to be interpreted. For subsequent statements, the findings are presented along with a brief summary of the results.

Statement 1: The objective of financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity

Auditors

Tests of Between-Subjects Effects					
Source	Type III Sum of Squares	df	Mean Square	F	p value
Corrected Model	9.429 ^a	12	0.786	2.967	0.001
Intercept	563.496	1	563.496	2128.135	0.000
Gender	0.558	1	0.558	2.106	0.148
Age	3.734	4	0.934	3.526	0.008
Years	2.042	4	0.511	1.928	0.107
Sector	3.156	3	1.052	3.973	0.009
Error	60.900	230	0.265		
Total	4642.000	243			
Corrected Total	70.329	242			

R Squared = .134

Table 5.21 – Statement 1: Test of Between-Subjects Effects (Auditors)

Parameter Estimates						
Parameter	B	Std. Error	t	Sig.	Interval	
					Lower Bound	Upper Bound
Intercept	3.877	0.379	10.221	0.000	3.129	4.624
[Gender=1] [G1]	-0.114	0.078	-1.451	0.148	-0.268	0.041
[Gender=2]	0 ^a					
[Age=1] [A1]	1.610	0.446	3.611	0.000	0.731	2.489
[Age=2] [A2]	1.424	0.415	3.432	0.001	0.607	2.242
[Age=3] [A3]	1.466	0.419	3.501	0.001	0.641	2.292
[Age=4] [A4]	1.300	0.430	3.024	0.003	0.453	2.147
[Age=5]	0 ^a					
[Years=1] [Y1]	-0.693	0.266	-2.601	0.010	-1.218	-0.168
[Years=2] [Y2]	-0.442	0.216	-2.045	0.042	-0.868	-0.016
[Years=3] [Y3]	-0.450	0.214	-2.104	0.036	-0.872	-0.029
[Years=4] [Y4]	-0.391	0.214	-1.829	0.069	-0.813	0.030
[Years=5]	0 ^a					
[Sector=1] [S1]	-0.496	0.152	-3.253	0.001	-0.796	-0.195
[Sector=2] [S2]	-0.475	0.153	-3.097	0.002	-0.777	-0.173
[Sector=3] [S3]	-0.526	0.157	-3.350	0.001	-0.836	-0.217
[Sector=4]	0 ^a					

Table 5.22 – Statement 1: Table of Regression Co-efficients (Auditors)

The four predictor model explains 13.4% of the total variation in the rating scores provided to this statement (Statement 1). The model identifies age and sector as being significant predictors because their p values are less than the 0.05 level of significance. The resulting model for auditors (Statement 1) is:

$$\text{Rating score} = 3.877 - 0.114G_1 + 1.61A_1 + 1.424A_2 + 1.466A_3 + 1.3A_4 - 0.693Y_1 - 0.442Y_2 - 0.450Y_3 - 0.391Y_4 - 0.496S_1 - 0.4755S_2 - 0.526S_3$$

Thus, by way of an example, on the basis of the above model, the expected rating for, say, a male auditor, aged between 41 and 50 years, having between six to ten years work experience and working in a Big Four audit firm would be

$$3.877 - 0.114 + 1.466 - 0.442 - 0.496 = 4.291$$

The results show that male auditors have scored, on average, 0.114 less than females. However, this difference is not significant. Auditors that are aged less than 60 years have scored on average between 1.30 and 1.61 higher than their counterparts that are older than 60 years. This difference is significant at the 0.05 level of significance.

Auditors with less than 30 years experience have rated this statement between 0.39 and 0.69 less than their counter-parts with more than thirty years experience, with the difference not being significant.

Another significant predictor that has been identified is the work sector. In fact, auditors in Big Four firms, other audit firms and sole practitioners have rated this statement around 0.5 less than those working in other sectors.

Shareholders

Tests of Between-Subjects Effects

Source	Type III Sum of Squares	df	Mean Square	F	p value
Corrected Model	5.176 ^a	12	0.431	1.017	0.434
Intercept	175.018	1	175.018	412.745	0.000
Gender	0.081	1	0.081	0.191	0.663
Age	1.235	4	0.309	0.728	0.574
Education	2.421	3	0.807	1.903	0.130
Years_shareholder	1.742	4	0.435	1.027	0.394
Error	101.344	239	0.424		
Total	4227.000	252			
Corrected Total	106.520	251			

R Squared = .049

Table 5.23 – Statement 1: Test of Between-Subjects Effects (Shareholders)

Parameter Estimates

Parameter	B	Std. Error	t	Sig.	Interval	
					Lower Bound	Upper Bound
Intercept	4.093	0.117	34.886	0.000	3.862	4.324
[Gender=1] [G1]	0.038	0.087	0.437	0.663	-0.134	0.210
[Gender=2]	0 ^a					
[Age=1] [A1]	-0.620	0.704	-0.881	0.379	-2.007	0.766
[Age=2] [A2]	0.181	0.305	0.592	0.554	-0.420	0.782
[Age=3] [A3]	-0.041	0.122	-0.338	0.735	-0.282	0.199
[Age=4] [A4]	-0.115	0.094	-1.223	0.222	-0.301	0.070
[Age=5] [A5]	0 ^a					
[Education=1] [E1]	0.085	0.392	0.216	0.829	-0.687	0.856
[Education=2] [E2]	-0.296	0.135	-2.198	0.029	-0.561	-0.031
[Education=3] [E3]	-0.007	0.094	-0.078	0.938	-0.191	0.177
[Education=4]	0 ^a					
[Years_s'holder=1] [Y1]	0.113	0.472	0.239	0.811	-0.817	1.043
[Years_s'holder=2] [Y2]	0.497	0.255	1.945	0.053	-0.006	1.000
[Years_s'holder=3] [Y3]	-0.011	0.112	-0.102	0.919	-0.232	0.209
[Years_s'holder=4] [Y4]	0.021	0.104	0.205	0.838	-0.183	0.225
[Years_s'holder=5]	0 ^a					

Table 5.24 – Statement 1: Table of Regression Co-efficients (Shareholders)

The model explains 4.9% of the total variation in the rating scores provided to Statement 1 by shareholders. The model does not identify any significant predictors because all p values are higher than the 0.05 level of significance. The resulting model is as follows:

$$\text{Rating score} = 4.093 + 0.038G_1 - 0.620A_1 + 0.181A_2 - 0.041A_3 - 0.115A_4 + 0.085E_1 - 0.296E_2 - 0.007E_3 + 0.113Y_1 + 0.497Y_2 - 0.011Y_3 + 0.021Y_4$$

Statement 2: Financial statements are useful to enable shareholders to monitor the past performance of a company.

Auditors

Tests of Between-Subjects Effects					
Source	Type III Sum of Squares	df	Mean Square	F	p value
Corrected Model	4.408 ^a	12	0.367	1.372	0.180
Intercept	582.781	1	582.781	2176.261	0.000
Gender	0.072	1	0.072	0.267	0.606
Age	1.008	4	0.252	0.941	0.441
Years	1.420	4	0.355	1.326	0.261
Sector	0.995	3	0.332	1.238	0.297
Error	61.592	230	0.268		
Total	4629.000	243			
Corrected Total	66.000	242			

R Squared = .067

Table 5.25 – Statement 2: Tests of Between-Subjects Effects (Auditors)

Parameter Estimates						
Parameter	B	Std. Error	t	Sig.	Interval	
					Lower Bound	Upper Bound
Intercept	4.643	0.381	12.173	0.000	3.891	5.394
[Gender=1] [G1]	-0.041	0.079	-0.517	0.606	-0.196	0.114
[Gender=2]	0 ^a					
[Age=1] [A1]	0.028	0.448	0.062	0.950	-0.856	0.912
[Age=2] [A2]	0.243	0.417	0.581	0.562	-0.580	1.065
[Age=3] [A3]	0.261	0.421	0.619	0.536	-0.569	1.091
[Age=4] [A4]	-0.028	0.432	-0.064	0.949	-0.879	0.824
[Age=5]	0 ^a					
[Years=1] [Y1]	-0.505	0.268	-1.886	0.061	-1.033	0.023
[Years=2] [Y2]	-0.228	0.217	-1.049	0.295	-0.657	0.200
[Years=3] [Y3]	-0.339	0.215	-1.576	0.116	-0.763	0.085
[Years=4] [Y4]	-0.263	0.215	-1.223	0.223	-0.687	0.161
[Years=5]	0 ^a					
[Sector=1] [S1]	-0.209	0.153	-1.362	0.175	-0.510	0.093
[Sector=2] [S2]	-0.284	0.154	-1.842	0.067	-0.588	0.020
[Sector=3] [S3]	-0.204	0.158	-1.293	0.197	-0.515	0.107
[Sector=4]	0 ^a					

Table 5.26 – Statement 2: Table of Regression Co-efficients (Auditors)

The model explains 6.7% of the total variation in the rating scores provided to this statement (Statement 2) by auditors. The model does not identify any significant predictors because all p values are higher than the 0.05 level of significance. The resulting model for auditors (Statement 2) is:

$$\text{Rating score} = 4.643 - 0.041G_1 + 0.028A_1 + 0.243A_2 + 0.261A_3 - 0.028A_4 - 0.505Y_1 - 0.228Y_2 - 0.339Y_3 - 0.263Y_4 - 0.209S_1 - 0.284S_2 - 0.204S_3$$

Shareholders

Tests of Between-Subjects Effects

Source	Type III Sum of Squares	df	Mean Square	F	p value
Corrected Model	6.785 ^a	12	0.565	1.285	0.228
Intercept	213.233	1	213.233	484.660	0.000
Gender	0.248	1	0.248	0.564	0.453
Age	2.111	4	0.528	1.200	0.312
Education	1.392	3	0.464	1.055	0.369
Years_shareholder	2.303	4	0.576	1.309	0.267
Error	105.151	239	0.440		
Total	4176.000	252			
Corrected Total	111.937	251			

R Squared = .061

Table 5.27 – Statement 2: Tests of Between-Subjects Effects (Shareholders)

Parameter Estimates

Parameter	B	Std. Error	t	Sig.	Interval	
					Lower Bound	Upper Bound
Intercept	3.985	0.120	33.351	0.000	3.750	4.221
[Gender=1] [G1]	0.067	0.089	0.751	0.453	-0.109	0.242
[Gender=2]	0 ^a					
[Age=1] [A1]	0.883	0.717	1.231	0.220	-0.530	2.295
[Age=2] [A2]	0.586	0.311	1.885	0.061	-0.026	1.198
[Age=3] [A3]	0.058	0.125	0.469	0.640	-0.187	0.304
[Age=4] [A4]	0.019	0.096	0.198	0.843	-0.170	0.208
[Age=5] [A5]	0 ^a					
[Education=1] [E1]	0.698	0.399	1.750	0.081	-0.088	1.484
[Education=2] [E2]	0.059	0.137	0.430	0.667	-0.211	0.329
[Education=3] [E3]	0.047	0.095	0.490	0.624	-0.141	0.234
[Education=4]	0 ^a					
[Years_s'holder=1] [Y1]	-0.024	0.481	-0.051	0.960	-0.972	0.923
[Years_s'holder=2] [Y2]	0.018	0.260	0.071	0.944	-0.494	0.531
[Years_s'holder=3] [Y3]	-0.014	0.114	-0.121	0.903	-0.238	0.211
[Years_s'holder=4] [Y4]	-0.208	0.106	-1.970	0.050	-0.416	0.000
[Years_s'holder=5]	0 ^a					

Table 5.28 – Statement 2: Table of Regression Co-efficients (Shareholders)

The model explains 6.1% of the total variation in the rating scores provided to this statement (Statement 2) by shareholders. The model does not identify any significant predictors because all p values are again higher than the 0.05 level of significance. The resulting model for shareholders (Statement 2) is:

$$\text{Rating score} = 3.985 + 0.067G_1 + 0.883A_1 + 0.586A_2 + 0.058A_3 + 0.019A_4 + 0.698E_1 - 0.059E_2 + 0.047E_3 - 0.024Y_1 + 0.018Y_2 - 0.014Y_3 - 0.208Y_4$$

Statement 3: Financial statements enable shareholders to predict future performance and future cash flows of a company.

Auditors

Tests of Between-Subjects Effects					
Source	Type III Sum of Squares	df	Mean Square	F	p value
Corrected Model	14.093 ^a	12	1.174	3.039	0.001
Intercept	222.381	1	222.381	575.478	0.000
Gender	1.254	1	1.254	3.244	0.073
Age	5.076	4	1.269	3.284	0.012
Years	7.875	4	1.969	5.095	0.001
Sector	1.357	3	0.452	1.170	0.322
Error	88.879	230	0.386		
Total	1901.000	243			
Corrected Total	102.971	242			

R Squared = .137

Table 5.29 – Statement 3: Tests of Between-Subjects Effects (Auditors)

Parameter Estimates						
Parameter	B	Std. Error	t	Sig.	Interval	
					Lower Bound	Upper Bound
Intercept	2.006	0.458	4.379	0.000	1.104	2.909
[Gender=1] [G1]	-0.170	0.095	-1.801	0.073	-0.356	0.016
[Gender=2]	0 ^a					
[Age=1] [A1]	1.779	0.539	3.303	0.001	0.718	2.840
[Age=2] [A2]	1.073	0.501	2.139	0.033	0.085	2.060
[Age=3] [A3]	1.077	0.506	2.128	0.034	0.080	2.074
[Age=4] [A4]	1.014	0.519	1.953	0.052	-0.009	2.037
[Age=5]	0 ^a					
[Years=1] [Y1]	-0.868	0.322	-2.697	0.008	-1.502	-0.234
[Years=2] [Y2]	-0.284	0.261	-1.088	0.278	-0.799	0.231
[Years=3] [Y3]	-0.513	0.258	-1.986	0.048	-1.023	-0.004
[Years=4] [Y4]	-0.696	0.259	-2.691	0.008	-1.205	-0.186
[Years=5]	0 ^a					
[Sector=1] [S1]	0.211	0.184	1.147	0.253	-0.152	0.574
[Sector=2] [S2]	0.291	0.185	1.571	0.117	-0.074	0.656
[Sector=3] [S3]	0.328	0.190	1.728	0.085	-0.046	0.702
[Sector=4]	0 ^a					

Table 5.30 – Statement 3: Table of Regression Co-efficients (Auditors)

The model explains 13.7% of the total variation in the rating scores provided to this statement (Statement 3) by auditors. The test identifies two significant predictors, namely age and the years of experience. The resulting model for auditors (Statement 3) is:

$$\text{Rating score} = 2.006 - 0.170G_1 + 1.779A_1 + 1.073A_2 + 1.077A_3 + 1.014A_4 - 0.868Y_1 - 0.284Y_2 - 0.513Y_3 - 0.696Y_4 + 0.211S_1 + 0.291S_2 + 0.328S_3$$

Shareholders

Tests of Between-Subjects Effects

Source	Type III Sum of Squares	df	Mean Square	F	p value
Corrected Model	6.794 ^a	12	0.566	1.544	0.109
Intercept	104.375	1	104.375	284.655	0.000
Gender	0.048	1	0.048	0.130	0.719
Age	0.712	4	0.178	0.485	0.747
Education	1.910	3	0.637	1.737	0.160
Years_shareholder	3.753	4	0.938	2.559	0.039
Error	87.634	239	0.367		
Total	2698.000	252			
Corrected Total	94.429	251			

R Squared = .072

Table 5.31 – Statement 3: Tests of Between-Subjects Effects (Shareholders)

Parameter Estimates

Parameter	B	Std. Error	t	Sig.	Interval	
					Lower Bound	Upper Bound
Intercept	3.148	0.109	28.859	0.000	2.933	3.363
[Gender=1] [G1]	-0.029	0.081	-0.361	0.719	-0.189	0.131
[Gender=2]	0 ^a					
[Age=1] [A1]	-0.247	0.655	-0.378	0.706	-1.537	1.042
[Age=2] [A2]	-0.037	0.284	-0.131	0.896	-0.596	0.522
[Age=3] [A3]	0.028	0.114	0.247	0.805	-0.196	0.252
[Age=4] [A4]	-0.096	0.088	-1.091	0.276	-0.268	0.077
[Age=5] [A5]	0 ^a					
[Education=1] [E1]	0.782	0.364	2.149	0.033	0.065	1.500
[Education=2] [E2]	0.123	0.125	0.984	0.326	-0.123	0.370
[Education=3] [E3]	0.029	0.087	0.328	0.743	-0.143	0.200
[Education=4]	0 ^a					
[Years_s'holder=1] [Y1]	-1.162	0.439	-2.646	0.009	-2.027	-0.297
[Years_s'holder=2] [Y2]	0.100	0.237	0.420	0.675	-0.368	0.568
[Years_s'holder=3] [Y3]	0.143	0.104	1.371	0.172	-0.062	0.347
[Years_s'holder=4] [Y4]	0.119	0.096	1.240	0.216	-0.070	0.309
[Years_s'holder=5]	0 ^a					

Table 5.32 – Statement 3: Table of Regression Co-efficients (Shareholders)

The model explains 7.2% of the total variation in the rating scores provided to this statement (Statement 3) by shareholders. The model identifies only one significant predictor, namely the number of years for which the shares were held by the shareholder. The resulting model for shareholders (Statement 3) is:

$$\text{Rating score} = 3.148 - 0.029G_1 - 0.247A_1 - 0.037A_2 + 0.028A_3 - 0.096A_4 + 0.782E_1 + 0.123E_2 + 0.029E_3 - 1.162Y_1 + 0.100Y_2 + 0.143Y_3 + 0.119Y_4$$

Statement 31: The company's financial statements are understood by shareholders.

Auditors

Tests of Between-Subjects Effects					
Source	Type III Sum of Squares	df	Mean Square	F	p value
Corrected Model	6.090 ^a	12	0.508	0.734	0.717
Intercept	216.489	1	216.489	313.201	0.000
Gender	0.354	1	0.354	0.512	0.475
Age	1.372	4	0.343	0.496	0.739
Years	2.127	4	0.532	0.769	0.546
Sector	0.161	3	0.054	0.078	0.972
Error	158.979	230	0.691		
Total	1936.000	243			
Corrected Total	165.070	242			

R Squared = .037

Table 5.33 – Statement 31: Tests of Between-Subjects Effects (Auditors)

Parameter Estimates						
Parameter	B	Std. Error	t	Sig.	Interval	
					Lower Bound	Upper Bound
Intercept	2.593	0.613	4.232	0.000	1.386	3.800
[Gender=1] [G1]	-0.090	0.126	-0.715	0.475	-0.339	0.159
[Gender=2]	0 ^a					
[Age=1] [A1]	-0.392	0.720	-0.545	0.587	-1.812	1.027
[Age=2] [A2]	-0.305	0.671	-0.454	0.650	-1.626	1.017
[Age=3] [A3]	-0.211	0.677	-0.312	0.756	-1.544	1.122
[Age=4] [A4]	-0.520	0.694	-0.749	0.455	-1.888	0.849
[Age=5]	0 ^a					
[Years=1] [Y1]	0.335	0.430	0.778	0.437	-0.513	1.183
[Years=2] [Y2]	0.515	0.349	1.475	0.142	-0.173	1.204
[Years=3] [Y3]	0.575	0.346	1.665	0.097	-0.106	1.257
[Years=4] [Y4]	0.460	0.346	1.332	0.184	-0.221	1.142
[Years=5]	0 ^a					
[Sector=1] [S1]	-0.068	0.246	-0.275	0.783	-0.553	0.417
[Sector=2] [S2]	-0.046	0.248	-0.187	0.852	-0.535	0.442
[Sector=3] [S3]	-0.005	0.254	-0.021	0.983	-0.505	0.495
[Sector=4]	0 ^a					

Table 5.34 – Statement 31: Table of Regression Co-efficients (Auditors)

The model explains 3.7% of the total variation in the rating scores provided to this statement (Statement 31) by auditors. No significant predictors were identified since all p values are higher than 0.05. The resulting model for auditors (Statement 31) is:

$$\text{Rating score} = 2.593 - 0.090G_1 - 0.392A_1 - 0.305A_2 - 0.211A_3 - 0.520A_4 + 0.335Y_1 + 0.515Y_2 + 0.575Y_3 + 0.460Y_4 - 0.068S_1 - 0.046S_2 - 0.005S_3$$

Shareholders

Tests of Between-Subjects Effects					
Source	Type III Sum of Squares	df	Mean Square	F	p value
Corrected Model	12.982 ^a	12	1.082	1.414	0.160
Intercept	62.859	1	62.859	82.153	0.000
Gender	0.500	1	0.500	0.653	0.420
Age	3.508	4	0.877	1.146	0.335
Education	4.709	3	1.570	2.051	0.107
Years_shareholder	2.619	4	0.655	0.856	0.491
Error	182.871	239	0.765		
Total	1517.000	252			
Corrected Total	195.853	251			

R Squared = .066

Table 5.35 – Statement 31: Tests of Between Subjects Effects (Shareholders)

Parameter Estimates						
Parameter	B	Std. Error	t	Sig.	Interval	
					Lower Bound	Upper Bound
Intercept	2.432	0.158	15.432	0.000	2.122	2.742
[Gender=1] [G1]	0.095	0.117	0.808	0.420	-0.136	0.326
[Gender=2]	0 ^a					
[Age=1] [A1]	0.312	0.946	0.330	0.742	-1.551	2.175
[Age=2] [A2]	-0.651	0.410	-1.589	0.113	-1.458	0.156
[Age=3] [A3]	-0.249	0.164	-1.517	0.131	-0.572	0.074
[Age=4] [A4]	-0.086	0.127	-0.681	0.496	-0.336	0.163
[Age=5] [A5]	0 ^a					
[Education=1] [E1]	1.208	0.526	2.296	0.023	0.172	2.244
[Education=2] [E2]	-0.095	0.181	-0.525	0.600	-0.451	0.261
[Education=3] [E3]	-0.062	0.126	-0.495	0.621	-0.310	0.185
[Education=4]	0 ^a					
[Years_s'holder=1] [Y1]	-0.841	0.634	-1.326	0.186	-2.091	0.408
[Years_s'holder=2] [Y2]	0.223	0.343	0.651	0.515	-0.452	0.899
[Years_s'holder=3] [Y3]	-0.136	0.150	-0.906	0.366	-0.432	0.160
[Years_s'holder=4] [Y4]	-0.111	0.139	-0.798	0.426	-0.385	0.163
[Years_s'holder=5]	0 ^a					

Table 5.36 – Statement 31: Table of Regression Co-efficients (Shareholders)

The model explains 6.6% of the total variation in the rating scores provided to this statement (Statement 31) by shareholders. No significant predictors have been identified. The resulting model for shareholders (Statement 31) is:

$$\text{Rating score} = 2.432 + 0.095G_1 + 0.312A_1 - 0.651A_2 - 0.249A_3 - 0.086A_4 + 1.208E_1 - 0.095E_2 - 0.062E_3 - 0.841Y_1 + 0.223Y_2 - 0.136Y_3 - 0.111Y_4$$

Statement 50: Financial statements appropriately communicate the limitations of financial reporting to shareholders.

Auditors

Tests of Between-Subjects Effects					
Source	Type III Sum of Squares	df	Mean Square	F	p value
Corrected Model	14.163 ^a	12	1.180	1.794	0.050
Intercept	195.392	1	195.392	297.024	0.000
Gender	2.430	1	2.430	3.693	0.056
Age	3.027	4	0.757	1.150	0.334
Years	5.644	4	1.411	2.145	0.076
Sector	0.228	3	0.076	0.116	0.951
Error	151.302	230	0.658		
Total	1931.000	243			
Corrected Total	165.465	242			

R Squared = .086

Table 5.37 – Statement 50: Tests of Between-Subjects Effects (Auditors)

Parameter Estimates						
Parameter	B	Std. Error	t	Sig.	Interval	
					Lower Bound	Upper Bound
Intercept	1.231	0.598	2.060	0.041	0.053	2.409
[Gender=1] [G1]	-0.237	0.123	-1.922	0.056	-0.480	0.006
[Gender=2]	0 ^a					
[Age=1] [A1]	0.768	0.703	1.093	0.275	-0.617	2.153
[Age=2] [A2]	1.179	0.654	1.802	0.073	-0.110	2.468
[Age=3] [A3]	1.240	0.660	1.878	0.062	-0.061	2.540
[Age=4] [A4]	1.154	0.678	1.704	0.090	-0.180	2.489
[Age=5]	0 ^a					
[Years=1] [Y1]	1.085	0.420	2.584	0.010	0.258	1.912
[Years=2] [Y2]	0.634	0.341	1.861	0.064	-0.037	1.306
[Years=3] [Y3]	0.456	0.337	1.352	0.178	-0.208	1.121
[Years=4] [Y4]	0.440	0.337	1.306	0.193	-0.224	1.105
[Years=5]	0 ^a					
[Sector=1] [S1]	-0.057	0.240	-0.239	0.811	-0.531	0.416
[Sector=2] [S2]	-0.053	0.242	-0.221	0.825	-0.530	0.423
[Sector=3] [S3]	0.012	0.248	0.047	0.963	-0.476	0.499
[Sector=4]	0 ^a					

Table 5.38 – Statement 50: Table of Regression Co-efficients (Auditors)

The model explains 8.6% of the total variation in the rating scores provided to this statement (Statement 50) by auditors. No significant predictors were identified since all p values are higher than 0.05. The resulting model for auditors (Statement 50) is:

$$\text{Rating score} = 1.231 - 0.237G_1 + 0.768A_1 + 1.179A_2 + 1.240A_3 + 1.154A_4 + 1.085Y_1 + 0.634Y_2 + 0.456Y_3 + 0.440Y_4 - 0.057S_1 - 0.053S_2 + 0.012S_3$$

Shareholders

Tests of Between-Subjects Effects

Source	Type III Sum of Squares	df	Mean Square	F	p value
Corrected Model	10.765 ^a	12	0.897	2.430	0.005
Intercept	82.075	1	82.075	222.359	0.000
Gender	0.062	1	0.062	0.167	0.683
Age	2.422	4	0.605	1.640	0.165
Education	3.423	3	1.141	3.091	0.028
Years_shareholder	3.184	4	0.796	2.156	0.075
Error	87.479	237	0.369		
Total	3105.000	250			
Corrected Total	98.244	249			

R Squared = .110

Table 5.39 – Statement 1: Tests of Between-Subjects Effects (Shareholders)

Parameter Estimates

Parameter	B	Std. Error	t	Sig.	Interval	
					Lower Bound	Upper Bound
Intercept	3.479	0.110	31.756	0.000	3.263	3.695
[Gender=1] [G1]	0.033	0.082	0.408	0.683	-0.128	0.195
[Gender=2]	0 ^a					
[Age=1] [A1]	-0.196	0.657	-0.298	0.766	-1.490	1.099
[Age=2] [A2]	-0.690	0.285	-2.421	0.016	-1.251	-0.128
[Age=3] [A3]	-0.130	0.114	-1.134	0.258	-0.355	0.096
[Age=4] [A4]	-0.044	0.088	-0.501	0.617	-0.219	0.130
[Age=5] [A5]	0 ^a					
[Education=1] [E1]	-1.096	0.365	-3.000	0.003	-1.816	-0.376
[Education=2] [E2]	-0.037	0.127	-0.294	0.769	-0.287	0.212
[Education=3] [E3]	0.014	0.087	0.163	0.870	-0.158	0.187
[Education=4]	0 ^a					
[Years_s'holder=1] [Y1]	-0.938	0.441	-2.129	0.034	-1.807	-0.070
[Years_s'holder=2] [Y2]	-0.331	0.239	-1.388	0.166	-0.801	0.139
[Years_s'holder=3] [Y3]	0.062	0.105	0.591	0.555	-0.145	0.269
[Years_s'holder=4] [Y4]	0.098	0.097	1.008	0.314	-0.093	0.288
[Years_s'holder=5]	0 ^a					

Table 5.40 – Statement 50: Table of Regression Co-efficients (Shareholders)

The model explains 11.0% of the total variation in the rating scores provided to this statement (Statement 50) by shareholders. Only one significant predictors was identified, namely the level of education. The resulting model for shareholders (Statement 50) is:

$$\text{Rating score} = 3.479 + 0.033G_1 - 0.196A_1 - 0.690A_2 - 0.130A_3 - 0.044A_4 - 1.096E_1 - 0.037E_2 + 0.014E_3 - 0.938Y_1 - 0.331Y_2 + 0.062Y_3 + 0.098Y_4$$

5.4 CONCLUSION

This Chapter has presented an explanation of the different stages involved in the quantitative phase of the study.

It started off by describing in detail the design of the research instrument and the sample selection process. It subsequently described the administration of the questionnaire, the analysis of the data and the response rates achieved.

Following this, the research findings emanating from the quantitative part of the study were presented. This included presenting the means, medians, minimum and maximum values, and the results of the t-test and Mann Whitney U-test for the two respondent groups with respect to the statements included in the questionnaire, as well as the result of the effect size test.

The quantitative research findings have indicated that the two surveyed groups, namely auditors and shareholders, were distinctly in agreement on the important role of communication in the financial reporting process, this being ranked as the most important use of financial statements. However, in terms of the message of financial statements, and the consequential need to establish the objective of financial statements, the two respondent groups shared different, and at times, contrasting views. Auditors focused on financial statements being used to present a true and fair view of the entity's financial performance and position, while shareholders focused on financial statements being used as a gauge of performance, in terms of the efficient, economic and effective use of resources entrusted to management. Shareholders believed financial statements were meant to show, in an accurate manner, how well an entity was managed and whether it had a sound internal control structure. The message of financial statements was, however, being negatively affected by their complexity. Shareholders expressed strong views on this, indicating that they may in fact be getting lost in the voluminous and technical information found in financial statements. Auditors agreed with this view, albeit to a lesser degree.

Empirical findings have therefore shown that there are significant differences across various themes relating to the subject matter under scrutiny, indicative of the existence of a gap in the expectations of auditors and shareholders on financial statements. This “gap” will be explored further in the subsequent qualitative phase of the study, which is the subject of the next Chapter.

CHAPTER SIX – INTERVIEWS: DATA COLLECTION, ANALYSIS AND RESEARCH FINDINGS

6.1 INTRODUCTION

This Chapter focuses on the collection and analysis of qualitative data in order to be able to answer the research questions of the study. The structure of this Chapter is similar to that of the previous one. It is essentially sub-divided into two parts: the first part of the Chapter (Sections 6.2 and 6.3) describes the design of the research instrument, the sample selection process, the administration of the interviews and the response rates achieved. The second part (Section 6.4) subsequently focuses on data analysis and the presentation of the research findings emanating from the qualitative phase of the study.

6.2 INTERVIEWS

This Section presents the design of the interview schedule, the choice of the sampling frames and its administration for the qualitative part of the study.

6.2.1 THE DESIGN OF THE SEMI-STRUCTURED INTERVIEW SCHEDULE

An interview schedule was developed in order to provide a consistent framework and coverage of the topics across all interviews. There were a number of reasons why an interview schedule was used in this study. As a start, the researcher wanted to ensure that all the key issues of the research topic would be covered. Secondly, using an interview schedule allowed the researcher to explore certain areas in more depth, by using probing questions that may not have been originally included in the interview guide (Smith, 1972). Thirdly, using an interview schedule enhanced “the comparability of the data collected across the interviews” (Flick, 2002, p.93). Finally, using an interview schedule “helps minimizing bias through the pre-specification of non-directive questions and probes” (Lillis, 1999, p.87).

The interview schedule served as a basic checklist to ensure that all the themes were covered during the interview. According to Patton (2002), the use of an interview schedule had the advantage of allowing the researcher to decide how best to use the time available for the interview and it improved the consistency with which the topics were covered. At the same time, an open-ended interview schedule allowed the interviewer to explore and probe interesting comments and issues as these are made in the course of the interview. Open ended questions facilitate the development of a good flow to the conversation between the interviewer and the interviewee and also enable a good rapport to be developed. Sullivan (2001, p.263) pointed out that “...even though interviewers will be familiar with the content of the interview, they still need good directions and devices such as contingency questions to ensure that they collect all information and do so quickly”.

The questions in the interview schedule were developed from an analysis of the valid responses that were collected in the quantitative phase of the study (Chapter Five). The interview schedule was structured in a way that the interviews would not be regimented ones. The scope of the study was to engage in exploring the different perspectives of the involved parties. In fact, the emphasis on particular questions varied according to what the interviewee wanted to discuss and probe further. Nevertheless, the use of an interview schedule ensured that the same basic information was obtained from each person interviewed. However, the interviewer remained “free to build a conversation within a particular subject area, to word questions spontaneously and to establish a conversational style, but with the focus on a particular subject that has been predetermined” (Patton, 2002, p.343).

The interview questions were carefully worded to explore further the key findings that emerged from the analysis of quantitative data. The interview schedule consisted of four Sections with the following headings: “General introductory question”, “The objective of financial statements”, “The message in financial statements” and “The Maltese environment”. It included a total of nineteen questions, divided as follows: one question as a background introductory question, six questions on the objective of financial statements, seven questions on the message of financial statements, and four questions

specifically related to the Maltese environment. The last question in the interview schedule was an open ended one, asking participants a broad question on whether they had any other comments they would like to add on the subject. This question was included to entice participants to talk further and give any other feedback they may have.

For the benefit of interviewees, the first question in the interview schedule was a factual and descriptive question, asking participants to briefly explain their involvement with general purpose financial statements. Whereas the collection of demographic data was left at the end of the questionnaire, in the case of the interview, the researcher sought to collect some background information at the start of the interview in order to be able to break the ice and also to get to know the participants better before actually asking the interview questions. This question was included in order to allow participants to become familiar and at ease with the interview situation, and also to develop trust in the researcher and the interview process. A relationship of trust in the interview process was also established through the assurance of confidentiality of the responses being given.

Probing questions were included in the interview schedule aimed at exploring the responses to those questions and themes where significant differences were noted in the quantitative part of the study. Thus, for example, question number two asked respondents “What do you consider to be the objective of audited financial statements?”, while question number nine asked respondents “Do you think that financial statements are precise, accurate and correct?”

The interview schedule was also subjected to a piloting exercise, in the same way that the questionnaire was (refer to Section 5.2.2). The scope was to identify any poorly worded questions and to ascertain whether quality data will be generated from the interview process. The pilot process also allowed the researcher to gauge the time to be taken in answering the questions, therefore ensuring that the interview does not become too long. The interview schedule was pilot tested with one auditor and one shareholder. A further session was held with the same academic specialising in auditing that was referred to in Section 5.2.2. Subsequent to this, certain questions were revised and simpler words were used in some cases.

The final interview schedule comprised a list of open ended questions. This is reproduced in Appendix 2.

6.2.2 SAMPLE SELECTION

The objective of this part of the data collection process is to gain an in-depth understanding of the issues rather than the generalisation of the issues. The data collected from the questionnaire survey was not considered enough to achieve all the research objectives, particularly as some of the questions required the researcher to find out in more detail the views of the respondent groups. For this reason, and also in view of the benefits of mixing different methods (as outlined in Chapter Four), it was decided that interviews would be held with a sample of auditors and shareholders.

In relation to sample sizes for interviews, Patton (2002, p.244) stated that:

“There are no rules for sample size in qualitative inquiry. Sample size depends on what you want to know, the purpose of the inquiry, what’s at stake, what will be useful, what will have credibility, and what can be done with available time and resources.”

The aim of the researcher was to collect quality data of a qualitative nature. In order to achieve this objective, Creswell (1998) identified three basic qualities that the participants needed to possess: (i) the expertise, knowledge and experience in the field that meet the conceptual and informational needs of the study; (ii) the ability to articulate their experiences and views; and (iii) the disposition and availability to share their experiences. In order to be able to locate such interviewees, it is clear that matters could not be left to chance observations. In this respect, the researcher’s background experience and personal contacts were important and they provided him with valuable indicators of potential interviewee candidates. Recommendations from other academics at the Department of Accountancy in Malta were also considered.

For the qualitative part of the research, purposeful sampling (also known as judgmental sampling) was used whereby the researcher selected the most “productive” sample to answer the research questions. This sampling approach is in sharp contrast to statistical

sampling as it cannot be planned. It is not possible to make a judgement regarding sample size before actually starting the data collection and analysis (Corbin and Strauss, 1998). Furthermore, judgmental sampling is not driven or ruled by methodological or representativeness criteria, but rather by the over-riding principle of relevance. Data collection leads to analysis, analysis leads to concepts and the concepts generate more questions. This iterative process continues until the research study arrives at a point of saturation. According to Corbin and Strauss (1998), theoretical saturation occurred when no new or relevant data emerged regarding a category, when the category was well developed and when the relationships among categories were well established and validated.

Under this approach, interviewees who have experience or are experiencing the phenomena under study are selected with the objective of gathering the most relevant and enriching quality data pertinent to the inquiry. In this way, persons who are “experts” and thus able to provide the best data available are included in the sample (Corbin and Strauss, 1998). The quality of the data collected is enhanced since the sample will include and will target the most knowledgeable persons, thereby highlighting the patterns, concept, categories and dimensions of the given phenomena (Corbin and Strauss, 1998). It was considered important by the researcher to collect rich descriptions by purposefully sampling a knowledgeable, varied set of participants (Morse, 2007). Judgmental sampling was applied in this study by including, for example, technical partners in audit firms who would be in a position to provide their technical insights on the subject matter. In the case of the shareholder group, the snowballing technique was also used to gain access to other respondents. Existing personal contracts were first used to conduct interviews with shareholders, and these contacts were then asked to identify other shareholders who may be interested to take part in the study. Given the close proximity of respondents within the local scenario and given that the researcher was based in Malta, using social networks such as Facebook or Twitter to gain access to respondents was not considered necessary.

A sample of fifteen auditors and fifteen shareholders was included in this study. The objective was to achieve a balance between the views expressed by auditors and those of

shareholders. Accordingly, it was decided that an equal number of interviews would be conducted with each of the two groups. The sample size chosen falls within the recommended sample size interval for interviews (Kvale and Brinkmann, 2009), particularly when considering a homogenous population (Guest *et al*, 2006) in order to reach data saturation and validity.

6.2.3 THE ADMINISTRATION OF THE INTERVIEWS

The questions used in the interview schedule for auditors and shareholders were identical. The objective of such an approach was to facilitate the process of comparing and contrasting the mutual perceptions of the two respondent groups. Although the researcher tried to follow the sequence of the questions set in the interview schedule, the contents of the interview was very much driven by the flow of the interviewees' thoughts. Thus, in certain cases, the researcher probed for more information, whereas in other cases, the researcher had to politely steer the interview back to the interview schedule in order to ensure that the interview session remained on track.

The semi-structured interviews were conducted on a face-to-face basis. Consideration was given to the possibility of conducting telephone interviews in order to speed up the data collection process. However, rapport can be harder to achieve on the phone for telephone interviews. Furthermore, in view of the minimal travel time necessary to hold the interviews given Malta's geographical size, it was decided that better insights could be obtained by holding face-to-face interviews. In addition, given the close proximity and availability of participants to take part in a face-to-face interview, using Skype or Viber to conduct the interviews was not deemed necessary.

The interviews were all conducted by the researcher. In qualitative studies, the researcher is the main instrument and therefore may introduce an element of subjectivity in the research process. This element of subjectivity can have a bearing on the research process. In this respect, the researcher's academic knowledge and practical experience in the auditing and accounting field were useful in the preparation of this study; at the same time, the researcher considered it important to make explicit this bias – this is not just a

mere statement of a potential weakness in the study, but also an acknowledgment of a possible influence on the data collection and interpretation. Indeed, as stated by Dey (1993) states, researchers cannot dispose of their accumulated knowledge and experience. Corbin and Strauss (2008, p.32-33), however, perceived value in the researcher's background to the study:

“Sensitivity or insight into data is derived through what the researcher brings to the study as well as through immersion in the data during data collection and analysis ... Theories, professional knowledge that we carry within our head inform our research in multiple ways... Our backgrounds and past experiences provide the mental capacity to respond to and receive the messages contained in the data.”

The most important consideration for the researcher is not to “lose sight of the data” and “work with concepts in terms of their properties and what the participants are saying” (Corbin and Strauss, 2008, p.33).

In this study, certain measures, being entrenched within the research process, were adopted to ensure the validity and reliability of qualitative data. There are different views on the characteristics and the methods for ascertaining validity and reliability in qualitative research. This study has followed Creswell's (1998) guidelines whereby the following procedural measures were implemented to enhance the credibility of the study. Table 6.1 summarises the steps adopted in this study for verifying the accuracy of the findings of the study.

Strategy	Action/s Taken
Prolonged engagement and persistent observation	Interviews conducted between 1/8/2016 and 15/6/2017
Triangulation	Quantitative findings (Chapter 5) and literature review (Chapters 2 and 3)
Peer review or debriefing	Discussion with academic specialising in auditing and financial reporting at the University of Malta
Role of researcher	Role of researcher explained in Section 6.2.2
Member checking	Verification of transcript with interviewees
Rich, thick description	Descriptions on participants (Section 6.4.3) and procedures adopted (Section 6.3)
External consultants	Interaction with supervisor and co-supervisor

Table 6.1 Strategies for verifying the accuracy of findings (adopted from Creswell, 1998, p.201-203)

This study adopts the set of measures proposed by Lincoln and Guba (1985) in judging the quality of qualitative data. One common criticism of qualitative studies that is made by quantitative researchers is that such studies fail to address the validity and reliability of data, as well the lack of generalisability of data. In addressing these limitations, Lincoln and Guba (1985) proposed the terms “credibility”, “transferability”, “dependability” and “confirmability” as being parallel to “internal validity”, “external validity”, “reliability” and “objectivity”, as shown in Table 6.2.

Quantitative Terms	Qualitative Terms
Internal validity	Credibility (confidence in the truth of findings)
External validity	Transferability (showing that findings have applicability in other contexts)
Reliability	Dependability (showing that the findings are consistent and could be repeated)
Objectivity	Confirmability (the extent to which the findings of a study are shaped by the respondents and not by researcher bias, motivation, or interest)

Table 6.2 Comparison of measures for judging quality of research

In order to ensure credibility, this study uses triangulation by searching for convergence among multiple and different sources of information with the objective of deriving themes therefrom. Furthermore, the participants in the interviews were given an information sheet and the questions before the interview so as to enable them to consider the questions ahead of the interview. Two of the shareholders decided to share copies of the annual report of listed companies where they are invested in order to support their views. Transferability is addressed through the rich descriptions that enable the reader to make decisions about the applicability of the findings to other settings and/or similar contexts (Creswell and Miller, 2000). Dependability was ensured by keeping a detailed record of the process adopted for the purpose of collecting and analysing the data, with the aim of enabling others to replicate and/or re-perform the analysis if required. Finally, to achieve confirmability, the researcher took steps to ensure that the findings emerged from the data, and not from his own predispositions. Thus, for example, during the interview itself, gestures or other forms of non-verbal behaviour by the interviewer were avoided to ensure that the interviewee did not perceive any bias based on the responses being given.

Gaining access to the participants was not always easy, particularly in the case of auditors due to their busy schedules and demanding work commitments. Initial contact was at times difficult; however, using e-mails and follow up telephone calls, the researcher was in a position to eventually set up the interviews. There were times when the interviewer was given direct telephone access to the interviewee, and this helped to speed up the process of agreeing a mutually convenient date to hold the interview. At other times, the interviewer was asked to contact the personal secretary of the interviewee in order to set up the meeting or alternatively to send an e-mail requesting an interview. There were only two instances where the interview did not materialize. This was because the researcher was given tentative appointments but these had to be re-scheduled, generally because of work commitments on the part of the interviewee. In the end, also duly keeping in view time constraints, the researcher opted to replace the two interviewees with two other participants.

6.3 THE COLLECTION AND ANALYSIS OF THE INTERVIEW DATA

For both groups (auditors and shareholders), the procedure for data collection was identical. An e-mail/letter was sent in advance to confirm the purpose of the study and to outline the questions to be used in the interview. A follow-up e-mail/telephone call was made to arrange and confirm the date, time and location of the interview. Before the start of each interview, the purpose of the study was fully explained again and the interviewee was re-assured of confidentiality and measures to secure their anonymity in reporting the findings of the study as well as in any future publications. Every effort was done during the interview to encourage participants to talk freely, in an open and informal manner. The researcher did his best to ensure that the interviewees were at ease in answering the questions. This was particularly relevant for the shareholders who did not possess the same level of technical expertise as auditors on the subject matter, but who nonetheless contributed to the study based on their experience. The questions were asked in a courteous and simple manner, and the researcher intervened only when necessary. At the end of the interview, after switching off the audio recorder, a number of interviewees proceeded to discuss the subject matter further in a very informal manner, particularly in the case of auditors who showed a genuine interest in the study and a wish to be informed about the findings. Practical insights were given, sometimes even citing specific examples to illustrate the point, in the knowledge that they were now no longer being recorded. This is indicative of the willingness of the Maltese audit profession to support research in the accounting and auditing field.

The number of individuals who participated in this part of study are shown in Table 6.3.

Respondent	Number of respondents
Auditors	15
Shareholders	15

Table 6.3 – Categorisation of sampled interviewees

The study therefore involved a total of thirty semi-structured interviews, fifteen with auditors and fifteen with shareholders in public listed entities in Malta. Nine of the auditors were from Big Four audit firms, three auditors were from mid-tier firms and the

remaining three were sole practitioners. The interviews all took place in Malta – the ones with the auditors generally were held at the offices of the interviewees, while the ones with the shareholders were either held at the shareholders' residence or at the interviewees' workplace. The interviews were conducted mainly in English, albeit that in some cases, a mix of English and Maltese was used according to the exigencies of the participants. Some participants, in fact, occasionally switched to Maltese in certain parts of the interview, particularly when stressing a point or citing some examples.

The majority of the interviews lasted between forty and sixty minutes. The interviewees generally made arrangements for a quiet, undisturbed meeting, such as by switching off mobile phones and advising others not to disturb during the meeting. In three particular cases, however, telephone calls were allowed through. At times, two participants had to interrupt the interview since they had to respond to some important query at the office. In such circumstances, as expected, the interview took longer than anticipated. There were some lapses in concentration at different points, but this did not detract from the overall quality of the data that was collected in the respective interview.

All of the interviewees were given assurance of anonymity in advance of holding the interview so as to encourage an open and honest debate on the subject matter. All of the interviews were digitally recorded, except for six interviewees (two auditors and four shareholders) who preferred not to be recorded (in such cases, notes were taken during the interview and these were then shared with the interviewee in order to build credibility). Using an audio recorder is a useful method of gathering interview data. According to Patton (2002, p.380):

“No matter what style of interviewing you use and no matter how carefully you word the questions, it all comes to naught if you fail to capture the actual words of person being interviewed. The raw data of interviews are the actual quotations spoken by interviewees. Nothing can substitute for these data: the actual things said by real people. That's the prize sought by the qualitative inquirer.”

The process of audio recording not only increased the accuracy of data collection, but it also allowed the interviewer to be more focused during the interview. Capturing interviews through the recording process also allowed the researcher to encourage

interviewees to focus on points being made, and also plan for the next question. Notes were still taken during the interview process. Notes allow the interviewer to be able to recheck statements or comments that the interviewee may have said earlier on in the interview. Taking notes also helped the interviewer to easily locate important quotations from the interview and therefore facilitated later analysis. Following every interview, details of the place, time and duration of the interview were recorded. Any specific observations related to the interview held were also noted.

The interviews were transcribed word for word in their entirety. Most of the interviews were conducted in English, though in some cases the respondents reverted to Maltese for some of their responses as typically happens in conversations between Maltese individuals. This is often the case when debating commercial, business and accounting related matters in Malta. Any parts that are quoted in this study were duly translated where applicable at the end of the process of analysis. The transcriptions were then analysed in detail on a line by line basis so that emerging themes could be identified. This process was supported by extensive memo writing to help the researcher in the process. Essentially, the first reading enabled the researcher to record first reactions in a first memo. Subsequently, when several themes appeared to be related, summary memos were compiled to combine and connect the themes together. In this way, the qualitative data was subject to careful exploration and rigorous analyses of the themes.

The triangulation of data from different sources helps improve the reliability of the findings. The researcher carried out interviews with both auditors and shareholders who are the main parties who have an interest in financial statements. This ensured that the findings reflected a complete view, but also a balanced one of the interactions observed between the two sides. The findings were validated by discussing the emerging themes with the interview subjects themselves. This helped to ensure that the findings had credibility on the basis that the findings are believable not only to the researcher, but also to participants and finally the readers of this research.

6.4 PRESENTATION OF FINDINGS

6.4.1 DATA ANALYSIS

The transcripts of the interviews held with auditors and shareholders were imported into Nvivo (Version 11). As part of the pre-coding process, the transcripts of the interviews were read over and over again. In this way, the researcher became increasingly familiar with the content of the transcripts and initial reflections on the data could be made.

In order to be able to use Nvivo, all transcripts were saved in Microsoft Word format. A new project was created in Nvivo and the various documents were then imported into Nvivo electronically. Different nodes were created in Nvivo reflecting the key themes being investigated (for example, “the objective of financial statements”, “stewardship” and “a true and fair view”). These nodes were created in Nvivo by dragging and dropping selected text from the uploaded transcripts onto a node. These nodes were subsequently assigned a name. The transcribed data was therefore sifted through on a line by line basis, and different quotes were assigned to the respective nodes. This is the process of how the actual coding started, and it proceeded on this basis, going through all the transcribed data. Coding is the process of sifting through large masses of data with the aim of making the most analytic sense to categorise the data incisively and completely (Charmaz, 2008). As this coding progressed, certain categories within the nodes required refinement, and this necessitated the rearrangement or refinement of categories. Certain nodes were removed in this process as they were considered redundant. Different colours were assigned to the codes in order to visually facilitate the coding process.

The use of Nvivo helped the researcher to index segments of text to particular themes and it was also helpful in pulling out quotations from the interviews to be inserted in the research findings. It was particularly beneficial in managing the large data set, allowing the researcher to search, manage and organize the mass of qualitative data collected in the interviews.

The final data layout consisted of a combination of direct quotations from participants being grouped under the respective nodes. The use of Nvivo also helped in word counts so as to identify the number of times a term was mentioned by the different interviewees.

The use of Nvivo helped the researcher to organise and manage the large volume of qualitative data available. However, a qualitative software programme such as Nvivo is not a substitute for the thinking process that the researcher has to go through. Indeed, as stated by Morse (2007), thinking, insights and interpretation remain within the realms of human investigation. The software was therefore treated for what it is – a tool that assists the researcher, but which is not a substitute for the researcher’s thinking process and for the process of bringing out meaning from data. In presenting the qualitative research findings, quotations were included, where applicable, so as “to allow the reader to enter into the situation and thoughts of the people represented” (Patton, 1990, p.429-430).

6.4.2 INTERVIEW MODE AND DURATION

Thirteen auditors and eleven shareholders gave their permission for the interview to be recorded, whilst the remaining six interviewees (two auditors and four shareholders) expressed their preference not to be recorded. Some explained that they were not comfortable in having their responses recorded, while others, particularly shareholders, advised that they were more versatile with the Maltese language and would therefore inevitably be switching to Maltese in their answers. The objective of the researcher was to encourage respondents to talk freely about the subject matter and therefore no pressure was exerted in those situations where respondents indicated their wish not to be recorded. In all cases, notes were taken during the interview, and after the interview, these notes were shared with the interviewee in order to build credibility.

Table 6.4 below shows the duration of the various interviews. The average time of interviews held with auditors and shareholders was 46 minutes and 43 minutes respectively.

	Auditors		Shareholders	
Duration (minutes)	Frequency	Cumulative Frequency	Frequency	Cumulative Frequency
30 – 40	3	3	7	7
41 – 50	7	10	6	13
51 – 60	4	14	2	15
61 +	1	15	0	15
	15		15	

Table 6.4. Interview duration

All interviews were conducted in Malta. Table 6.5 shows the location of where the interviews were conducted:

	Auditors		Shareholders	
Location	Frequency	Cumulative Frequency	Frequency	Cumulative Frequency
Interviewee's office	13	13	6	6
Private residence	0	13	5	11
Interviewer's office	2	15	4	15
	15		15	

Table 6.5 Interview location

6.4.3 PARTICIPANT DEMOGRAPHICS – AUDITORS AND SHAREHOLDERS (Q1)

Information on the participants' demographics was collected at the start of the interview. The information presented in this section also includes the responses given by the interviewees to the first question of the interview schedule. This question asked the interviewees to explain their involvement with general purpose financial statements and therefore provide background information about themselves.

Out of the thirty interviews conducted by the researcher, twenty six were made with males, while four were made with females. The interviewees' gender can be further subdivided according to the two respondent groups as follows: thirteen interviews were conducted with male auditors and a further thirteen interviews were done with male shareholders; on the other hand, two interviews were conducted with female auditors and another two interviews were done with female shareholders.

The majority of the interviewees (thirteen in total) were 41-50 years old. The age distribution of the remaining interviewees was as follows: one interviewee was 31-40 years old, nine interviewees were 51-60 years old, and seven interviewees were more than 60 years old. The age distribution of the interviewees can be further analysed by respondent group as follows:

Age (years)	Auditors		Shareholders	
	Frequency	Cumulative Frequency	Frequency	Cumulative Frequency
31 – 40	1	1	0	0
41 – 50	7	8	6	6
51 – 60	5	13	4	10
61 +	2	15	5	15
	15		15	

Table 6.6 Interviewees' age

All interviewed auditors were in possession of a practicing certificate in auditing. They were also asked to advise the type of audit firm with whom they worked. Results show that nine interviewees worked with Big Four audit firms, three auditors worked with other audit firms (e.g. medium sized partnerships) and three auditors were sole practitioners. Two auditors were retired auditors, albeit that they still followed developments within the profession and were in fact still active on this front.

All interviewed shareholders confirmed that they owned shares in companies listed on the Malta Stock Exchange. It was only one shareholder who confirmed that he was

actively involved in trading activities, either buying or selling shares at least once every quarter. All the other shareholders confirmed that they had not acquired or sold any shares during the past twelve months, and that any movement in their shareholdings was only attributable to bonus issues, share splits or scrip dividends that may meanwhile have been executed by the listed companies.

6.4.4 QUALITATIVE RESEARCH FINDINGS

6.4.4.1 THE OBJECTIVE OF FINANCIAL STATEMENTS (Q2, Q4)

The second question in the interview schedule asked respondents to express their views on the objective of preparing financial statements. The scope of this question was to elicit the respondents' views on a crucial, if not the most fundamental, aspect of the financial reporting process – the specification of the objective of preparing financial statements. Indeed, one auditor commented that “it is opportune to start with a question on the objective of preparing financial statements as this should be the very fundamental subject on which all standards ought to be based”.

(i) The financial performance and state of affairs of the reporting entity

According to the majority [9 out of 15] of the interviewed auditors, the objective of preparing financial statements is to provide information on the financial performance and state of affairs of the reporting entity for a past reporting period. In answering this question, given their professional auditing background, auditors were invariably cross-referring to certain concepts from the auditing field, particularly the concept of truth and fairness and certain other terminology included in an audit report, to which they could readily relate to. In fact, answers given to this question included the following:

“...the simple answer I suppose is to give a true and fair view of the performance and of the financial position of an entity to its shareholders and also to other users who may be interested in those financial statements”

“...to give a true and fair view, or present fairly, in all material respects, the financial performance, financial

position and changes in the financial position over a reporting period...”

“...presentation to certain users groups, and today these are primarily the owners of the business and the lenders to the business in some form or shape...basically the state of affairs, performance for a particular period, cash flows of course, and the position at the particular point in time”

“...they are providing a true and fair view”

“...financial statements and general purpose financial statements are basically prepared to present ...obviously depending on the year end, the present financial situation of an entity, being a company, being a partnership, being an organisation, whatever that is, in accordance with standards obviously, because we need to follow rules, and in accordance with the law”

“I find it very clear that the financial statements principally depict the financial performance of that entity for a particular period of time, which is fundamental for the providers of capital and basically shows the return on the capital for those providers of capital”

“...they are giving sort of a statement of what happened from a financial perspective, the operations of the company, the financial performance of the company”

In the above seven quotations, there are references to “truth and fairness” or “a true and fair view” or to a statement that provides information on the “state of affairs” or “financial performance / position” of the reporting entity.

Different terms were used to describe financial statements. In certain cases, the interviewed auditors drew on analogies to make their point. One auditor believed that financial statements were “the very basic level of information that one needs”, while another auditor considered them to be “an important report on the financial situation”. Another auditor commented that financial statements were prepared “to get an indication of the performance of last year” while another auditor believed that “financial statements are meant to give a snapshot at that particular point in time”. Other terms that were used to describe financial statements included the following: “a historical snapshot”, “reporting on historical information”, “a summary, a statement of what happened in the

company, in the last year”, “an important tool”, “an indication of the performance of last year” and a means of “taking stock of a position once a year and documenting that position”. One auditor, however, went beyond these considerations, describing financial statements as a tool that provides information on “financial health”, stating that financial statements gave “a historical snapshot at a given time of the performance of the company and the financial health of that company [emphasis added] at that point in time”.

In explaining their answers, the auditors that considered reporting on the financial performance and state of affairs of the entity as the objective of financial statements also made reference to the intended user or users of financial statements. Different extremes could be noted here – at one extreme, some auditors [3 out of 15] believed that financial statements should be directly solely, or primarily, to shareholders; at the other extreme, other auditors [12 out of 15] believed that the objective of financial statements was to report information that could be fruitfully used by a much wider, at times unspecified, audience. In their responses, all auditors however referred, directly or indirectly, to the shareholders as the intended users of financial statements. One auditor remarked that “the primary responsibility, I think, must remain towards the shareholders and it is dangerous that sometimes that responsibility grows beyond where it should”.

Another auditor however referred to “user groups”, that included shareholders but that also included other “lenders to the business in some form or shape”. Other auditors referred to “providers of finance”, citing bankers and bondholders as examples. Another auditor widened this to include “people doing business with the company, people needing to understand the financial position of the company” while another auditor even went beyond this, describing financial statements as including transactions that are “all translated into one document at the end of the year, and numerically, to disclose this picture to whoever is interested [emphasis added] in seeing it”. Furthermore, one auditor remarked that financial statements could also “ultimately end up in the hands of people who don’t really ask for financial statements, but sort of, ending up having them”.

Whilst auditors were generally focusing on the provision of information on the financial performance and state of affairs, shareholders expressed different views on the objective

of financial statements. Some shareholders [4 out of 15] followed a similar line of thinking as the auditors, describing the objective of financial statements as being “to look at the history of the company”, “to have an overview of the past performance, the profit or loss of the company”, “to prepare historical statements”, “to report on the past performance and on the value of the entity”, “a representation of the financial position and performance of an entity in question” and “a picture... of what the company has done during the previous twelve months”. Other shareholders [7 out of 15] went beyond these considerations, describing the objective of financial statements using the following comments:

“... to assist all the parties, all the stakeholders of the business, to understand better the operations, how the company is performing”

“... understanding mostly the equity, how far the value of the company has been growing over the years and also in terms of the cash position, cash flow position of the company, how it can continue to meet its obligations”

“... the financial statements give a true picture of the business operations and how management is operating its assets”

“it’s really a certificate [emphasis added], an opinion about what has happened”

“... the most important objective of having these audited financial statements is to see whether the entity’s plan or budget has been achieved or not”

“... the objective of financial statements, I think, it’s to report to shareholders how their investment has performed”

“... giving a picture of where costs have been cut, where expenses have increased, where income has increased or income has gone down, to then take corrective action for the following years”

“... to see how robust the company or the entity is, how well it is performing”

Thus, whilst auditors were generally in agreement that the objective of financial statements was to provide information of the financial performance and financial position

of an entity, shareholders have expanded this objective significantly. This is because shareholders related financial statements not only to financial performance/position of the reporting entity, but have also extended them to provide information on “equity”, “robustness”, “where costs have been cut”, adherence to “an entity’s plan or budget” and “how their investment has performed”. One shareholder even referred to a “certificate”, which is in sharp contrast to the auditors’ focus on truth and fairness, and the reasonable assurance (as opposed to absolute assurance) that an audit engagement can afford.

(ii) *Reporting on stewardship*

The interviewed auditors and shareholders referred, directly or indirectly, to the concept of stewardship in explaining the objective of financial statements. Auditors were more inclined to repeatedly refer to stewardship in their answers, and in fact, eight auditors referred to this term when answering this question. Different adjectives or terminology were used to stress the importance of stewardship – three auditors described stewardship as the “primary objective of financial statements”; one auditor described stewardship as “an important aspect” both for private and listed companies; another auditor considered stewardship as being “integrated into the reason, into the concept, into the fabric of financial statements”.

One auditor gave his own personal understanding of the historical origins of accounting in order to make his point:

“Financial information....started in Venice many, many years ago, when a shareholder would ask a ship captain to go to the Far East and he would invest into the ship to get spices, etc... At the end, when the captain used to return, he would give financial reports of what he bought, what stock he holds, how he used the investor’s money, so the financial statements, the use of the financial statements is to report to the investor, in our case today, the shareholder, on how the captain, today, it’s the director, has used the shareholder’s money in a particular period of time.”

Other auditors also referred to stewardship in their answers by explaining that in their opinion, financial statements were “an account of the stewardship of the board” and that they showed “how...the board has implemented its responsibility, and with what results”. Another auditor remarked that financial statements communicate “what it [the board] has

done during the year under review....how it has looked after the assets and liabilities, in what it thought to be the best way for shareholders” and that they showed whether “the company has been run diligently”. One auditor made a distinction between family owned companies and other companies where ownership is more widely dispersed. He commented that although stewardship may not be relevant for family companies in their first or second family generation, as time passes, one will have “cousins and the younger brothers and sisterswho would want to see the accounts to see how things are going, so ...the stewardship aspect in the context of Malta is very important”.

There were two auditors who, however, were very skeptical on the applicability of the stewardship concept. One auditor justified this view on the basis of the widespread shareholder base of companies, arguing that:

“I think the traditional part of stewardship has become confused... because of the widespread shareholdings that we have nowadays. I mean who owns the company? Who owns the company? Unless it is some Donald Trump , Warren Buffet, Mark Zuckermann...unless it's someone like that, it's very difficult to know who owns a company, Steve Jobs or whoever”

“...it has become so widely, thinly spread, ownership, that the identity of the owners is lost and it is very convenient for the stewards”

Another auditor was cynical on reference to stewardship being made as the objective of financial statements. According to this auditor:

“...we say that financial statements are prepared for stewardship purposes – but they do they really give an account of stewardship? Do they really show how well management used the company's assets? Do they talk about efficiency or effectiveness? Do they include reference to what the market has performed? The answer is No.”

Some shareholders were likewise also critical on the extent to which stewardship could be considered as the true objective of preparing financial statements. The general view of shareholders [9 out of 15] was that financial statements were meant [emphasis added] to be a gauge of management performance and that they felt that financial statements should [emphasis added] show whether a company was well managed. To use an

expression of one shareholder, “that is what financial statements should focus on – how well managed the company was”. However, as one other shareholder admitted, “in practice, this is not the case”.

In answering this question, one shareholder admitted that shareholders have “little power as individuals”, and that unless some form of class action or shareholder activism (which was described as being difficult to obtain in Malta) was initiated, there was very little that shareholders could do to have an impact on the management of the entity. This shareholder commented that:

“...shareholders have very little power as individuals, considering their smaller shareholding. Obviously, the larger shareholders do not really need the financial statements because they are already represented on the board and they are seeing up-to-date information, management information... So the relevance for the larger shareholders is really insignificant.”

Other shareholders [3 out of 15] were also critical of the extent to which financial statements could be said to be aimed at addressing stewardship, especially considering the frequency (annual or bi-annual) with which they were submitted to shareholders and the fact that financial statements did not include information on the effectiveness with which resources were used. These shareholders commented that it was:

“...very comforting that you have a year where you don’t really need to communicate with shareholders, and you are running the organisation without any interference, but you know that once a year you have to report what you’ve been doing and you have to answer for this”

and that

“the financial statements per se don’t because financial statements give you financial results. Now that doesn’t show in itself how well those assets have been managed”

and that financial statements were not

“... the real true measure of management stewardship. I mean the financials themselves don’t give you certain information”

Other shareholders [2 out of 15] were more inclined to agree with auditors on stewardship being the objective of preparing financial statements. In fact, financial statements were

described as “a judge of management” and an evaluation “of how has the Chief Executive Officer performed”. They were also described as a way of showing that “the assets that have been entrusted to the management of the company, are being managed in a manner which is in the interest of the company”.

Auditors therefore gave a higher weighting to financial statements fulfilling the stewardship function than shareholders did. Shareholders considered that stewardship ought [emphasis added] to be an objective of financial statements, but that in practice, financial statements were not providing them with the necessary information to provide a true measurement of management’s stewardship.

(iii) *Decision-making*

Decision-making was another objective that the interviewed auditors [7 out of 15] referred to when answering the first question. Question four of the interview schedule included an interpretation issued by the IFRS Foundation on the IASB’s objective of financial statements which focused on financial statements being useful to users in making decisions about providing resources to an entity. This question sought to elicit the respondents’ view on this interpretation.

One auditor commented that financial statements were prepared so that they can be “used for investing purposes” and that they were “used to an extent by lenders, such as banks for example, although banks have their own way of looking at certain things”. Other auditors [six out of fifteen] referred to financial statements as being necessary for the decision making process, albeit “not on their own” and that the use of financial statements for decision making should be coupled with the use of other information. Financial statements were described as being “useful” for decision making, but that they “should not be the only thing that an investor has to look at or the only thing that a lender has to look at” when making economic decisions. The following comments were relevant on this point:

“I think that when deciding whether to provide more resources to an entity or not, you need financial statements, you need a business plan also ... you need some kind of

future looking statements. Some kind of future looking at numbers and plans”

“I would say that they can assist users in making decisions about providing resources to the entity, but they're supplementary to other information that is often not contained in financial statements”

The interviewed shareholders [6 out of 15] considered financial statements as “helping them in making decisions about investing in the entity”. Three shareholders commented that financial statements:

“help you to make and understand better your decisions, in either increasing or decreasing the investment that you have, or whether the company itself ... is providing the resources to meet the obligations it has”

“...I select certain items of the profit and loss account, and of the balance sheet, and certain assets and liabilities, and compare those figures let's say over three, four, five years to see a trend, to see whether things are improving and why, or whether things are not improving and why”

“help us to a great extent in our decisions where to invest, how much to invest because we are trying to diversify and not trying to put all our eggs in one basket”

However, when it comes to decision-making, four shareholders [4 out of 15] made reference to the important role played by their stock-broker. One shareholder believed that investors “were very much in the hands of brokers”. Another shareholder stated that he trusted his stockbroker and that “since I don’t do any research myself on what is going round in financial circles, I normally take the advice of the broker”. Another shareholder commented that “many of the investors depend on what the stockbrokers tell them, really” and that “...stock-brokers actually carry a lot of responsibility[since] most just follow what the stockbroker recommends”. Another shareholder remarked that:

“....ultimately my stockbroker comes into the picture as well. I have had the same stockbroker for the past twenty five years and his insight helps me in, not my ultimate decision, but he can direct me and then I can say yes or no”

Thus, auditors have considered financial statements to have a more critical role in the

decision-making process, albeit that they highlighted the need for them to be used in conjunction with other sources of information. Shareholders have, on the other hand, acknowledged the important role of financial statements in investment decisions, but have also outlined the importance of other external factors or players, particularly stock-brokers in this process.

(iv) *Communicating financial information*

The interviewed auditors and shareholders also recognised the importance of communication in the financial reporting process. Auditors [5 out of 15] perceived financial statements as being a tool to communicate financial information. Different auditors gave a different interpretation as to what was being communicated to shareholders as follows:

“...to communicate in numbers what happened in a year, so all that happened in a year, the successes and failures, the new clients that came in and the investments the company did, the stock which the company had throughout the year”

“It's all about communicating, communicating your performance”

“...the business provides, produces reports to communicate its performance to the stakeholders, the stakeholders whoever they maybe, the investors themselves and the creditors”

“When it comes to a sophisticated business and companies, then it is communication; it's a more clear objective, there is more clear scope of communication between the people entrusted with the business and the people investing the money into the business. So, that is the basic objective of all the financial statements”

“The objective of preparing financial statements is to communicate information. Unfortunately, I think accountants or the preparers of financial statements have never understood that they are in fact in the communication business. Whether we like it or not, that's the truth. Which means that the information has to be communicated in an effective way”

One auditor extended the communicative aspect of financial statements to also include the communication of the “image” of the company. He commented that:

“it puts across ... an image, an image of the company; so whilst it may not be a primary objective, it does provide a tool for the company to communicate its ... ethos, its mission statements, its values and how those have resulted in an economic performance, be it a profit or loss”

Another auditor admitted that the profession had still not managed to find the best way to communicate with the target audience. This practitioner, drawing on his experiences over the years, admitted that:

“...throughout my career, from the very beginning, from my student days, I remember the profession always trying to find the best way to communicate information, the best way to present it, the best way to disclose it, the best way to aggregate it in groupings and things that make it easier for the shareholder to understand”

but, that the:

“...exercise is ongoing; we are still looking for the Holy Grail ... we have never really found the exact right formula, how to have users of financial statements saying oh, at last, I can see clearly alright!”

Shareholders could also readily relate to the communicative aspect of financial statements. In fact, the terms “communicate” or “communication” were mentioned over fifteen times in the interviews with shareholders. One shareholder remarked that financial statements were “an opportunity to communicate with your shareholders” but that unfortunately, this opportunity was being “missed” because of the financial statements that were “many pages long”. Another shareholder remarked that financial statements were an important “channel of communication” but that this channel was “ineffective in delivering the message it purportedly wants to deliver”. Another shareholder described financial statements as a “communications link” while another shareholder talked about financial statements as being a “medium” of communication. The importance of communication for shareholders was manifested when shareholders were talking about the problems of understanding the message of financial statements. The point made by all shareholders was that due to a number of factors (as outlined in Section 6.4.4), the

message of financial statements was not being understood and this hindered the effective communication that was so fundamental to the financial reporting process.

(iv) *A compliance exercise*

In answering the question on the objective of financial statements, auditors also referred to another pragmatic reason for the preparation of financial statements, particularly in the case of small owner-managed companies – a compliance exercise. The interviewed sole practitioners [3 out of 15] had particularly strong views on this matter, given their day-to-day experience in dealing with the smaller companies. However, partners in Big Four audit firms also admitted that, on a pragmatic level, satisfying regulatory and tax obligations played a major role in financial reporting in Malta. There were various comments in discussion that focused on compliance, such as “I think they are prepared for compliance purposes”, “I still have to prepare them”, “the objective is for many of them...purely compliance”, “it’s a regulatory obligation, there are tax obligations in Malta...there’s a tax obligation that you need financial statements”, “to fulfill regulatory obligations”, “to satisfy such tax obligations and other regulatory obligations, such as the need to file the financial statements with the Registry of Companies” and “they are obliged to do so [prepare financial statements] by the Companies Act and by the Inland Revenue Department”. One sole practitioner was particularly pragmatic in admitting that:

“they [shareholders] do not really bother to see the accounts; they are just prepared ...by me, and they go straight to their shelves”

and that:

“they are prepared to fulfill the regulatory obligation, maybe to have a record of financial performance, but once it’s done, you shelf it, it’s done, it’s closed”

Another sole practitioner summed it all up by stating that, in his opinion, the preparation of financial statements was:

“... an exercise that has to be done. It’s part of the timetable, calendar, in a company”

Fulfilling the regulatory obligation of preparing financial statements was, however, not

only referred to in connection with small companies. In fact, some auditors [2 out of 15] specifically stated that the preparation of the financial statements for listed entities had also become a compliance driven exercise. One auditor commented that the preparation of financial statements had become “a very compliance oriented close yourself in a room exercise”, that necessitated specialist inputs from IFRS trained staff members, and that a lot of staff time and effort was invested in ensuring that all IFRS requirements were duly fulfilled, particularly on the disclosure front. In fact, this auditor referred to the various checklists used by the firm to ensure that all disclosure items required by IFRS were properly reflected in the financial statements. This auditor commented that:

“Sometimes I wonder if people value the time, effort, and ultimately the cost of preparing the financial statements. It has become a tick the box exercise, ensuring that all items to be disclosed are indeed there. Otherwise, we will have problems with quality inspectors and regulators. It has become a compliance exercise – ensuring that the financial statements comply with the standards”

Some shareholders [2 out of 15] also referred to fulfilling regulatory requirements in preparing financial statements. One shareholder made a distinction between small and larger companies, commenting that the preparation of the financial statements for the smaller companies was “an exercise that needs to be done”. This shareholder was also of the opinion that even in the case of the larger companies, who may have their equity or bonds listed, the preparation of financial statements was also taking shape as a compliance exercise since “listed companies keep to the bare minimum of what regulations state”. Another shareholder commented that financial statements were prepared “because of the law, because of the law in so far as statutory requirements...very often that is the answer, because of the law”.

References to fulfilling regulatory requirements were, however, far less common in the case of shareholders. Thus, auditors have attributed a much greater importance to the compliance function when it comes to the preparation of financial statements.

(v) *A single set of financial statements with many objectives*

As one interviewed auditor explained, “I think that there is more than one objective why

financial statements are prepared”. In fact, in answering this question, interviewed auditors [5 out of 15] repeatedly made reference to “general purpose financial statements”, explaining that the preparation of such financial statements was meant to “generally” address the requirements of different user groups. In talking about different objectives, one auditor remarked that we are “using that same set of financial statements to achieve that objective too”. Another auditor was critical of the appropriateness of using a single set of financial statements to achieve many objectives, commenting that “if you obfuscate the objective, you are obviously going to obfuscate the message as well”. This auditor opined that the problem with financial reporting was that financial statements were trying to “achieve different objectives from what was originally set for a specific objective”. In fact, he recommended that:

“... perhaps someone... should come to a notorious decision: let us not have two things out of this, so let us go back again, leave them as they are and let us prepare some other kind of information which would be issued”

One auditor described the situation as a “one size fits all” situation. According to this auditor, different users have different objectives and users were therefore “looking at it [financial statements] from a different angle. But we have the same set of financial statements”. This auditor remarked that over the years, layers and layers of disclosures to financial statements had been added, such that financial statements “have grown bigger and bigger”, with standard setters “always patching up” to cater for the requirements of some particular user group. According to this auditor, general purpose financial statements should be retained and other special purpose financial information should be devised to satisfy the expectations of other interested parties. Another interviewed auditor also referred to the fact that “different users would be different” and that they “have...different perspectives of what financial statements are”. One auditor pointed out the danger with the current situation, advising that in practice, there was the risk that unspecified users could be “using them [financial statements] for a scope for which they were not meant”. One auditor summed it all up by asking a question:

“How can a single set of financial statements fulfill the expectations of all users: present investors, future ones, bankers, tax, creditors, unions, customers, suppliers

etc...everyone....everyone... the list is endless. Is it possible that financial statements are fit for purpose for all these people? I would prefer focusing on who I consider to be the prime users of financial statements”

Some interviewed auditors [2 out of 15] were critical on the role of the IASB in the standard setting process, attributing the lack of clarity on the objective and users of financial statements to the present situation. One auditor remarked that an increasingly globalised world was very much dependent on agreement being reached between many different countries and different jurisdictions having varying interests. This was also the case with the standard setting, which was manifested in the various options available under IFRS and the fact that standards ended up being “fudged” in order to appease various interests. This process was described by another auditor as a process of “hijacking financial statements” to satisfy the interests of investment analysts in bigger jurisdictions. In fact, another auditor remarked that countries that have adopted IFRS across the board for statutory reporting purposes have essentially “taken in a concept, which was not born within the concept of annual accounts, because they [standards] were prepared for stock exchanges”. One auditor made reference to an “expectation gap” in financial reporting, citing the different expectations of the different user groups out of financial statements as a contributing factor to this phenomenon. This auditor commented that:

“...maybe suppliers would need more information on the credit worthiness of the company than what is disclosed in the financial statements. Maybe employees need more information on how resources are distributed within the company beyond what’s disclosed in the financial statements”

One shareholder described financial statements as being “a great deal of use for third parties. Creditors can rely on them. Banks can rely on them. Potential investors can rely on them”. Other shareholders were, however, concerned at the effect of preparing a set of financial statements that was aimed at satisfying various users. In explaining this effect, reference was repeatedly made to “complexity”. One shareholder explained that in trying to come up with a comprehensive document for all users, accountants have sought to “accommodate the interests of every user, or indeed every category of users” and that financial statements had therefore become “books” or, as another shareholder described them, “the size of Bibles”.

One particular shareholder, having an accounting background, opined that financial statements had grown from a tool that was intended with a “specific purpose” to a “multi-purpose” document. He stated that the more users will depend on financial statements, the more complex financial statements will become and consequently, the less useful financial statements will become for each group. In explaining his view, this shareholder stated that:

“...every different type of user has a different angle to view the financial statements. Banks have one view of financial statements, potential investors have a different view. Current investors have a different view. So each category of user has a different view... what I think is actually wrong is that financial statements originally intended to accommodate one set of user and now we are trying to accommodate all possible users”

In elaborating further on this point, this shareholder explained that the word “users” was open-ended and that accountants were “bending over backwards....to compromise on what the original task was...which in all fairness is counter-productive”. He was of the view that the use of financial statements could perhaps be extended to accommodate a limited number of “additional users” but that they could not be “extended to satisfy...one hundred per cent of all these users”. He also opined that financial statements have ended up being a “compromise” and that:

“there should be no compromise in what is being presented. A user should know the limitations of financial statements whether he is a professional seasoned accountant or whether he is somebody seeking to understand what went through the company last year”

Both auditors and shareholders, therefore, were critical of the ability of a single set of financial statements to satisfy many objectives contemporaneously, arguing that one single set of financial statements may not be fit for purpose in all circumstances and for all users at the same time.

6.4.4.2 THE USE OF FINANCIAL STATEMENTS (Q3, Q6, Q7, Q18)

The third question in the interview schedule asked the interviewees to explain what they considered to be the main use of financial statements. This question therefore builds on

the second question by asking participants to discuss the use/s of financial statements.

(i) *To assist bankers and lending institutions*

All interviewed auditors described banks or lending institutions as one of the main user groups who would refer to financial statements when deciding whether to extend credit to a client company. Different contrasting views were, however, expressed on the extent to which financial statements were actually used for this purpose. Two auditors remarked that whilst banks referred to financial statements, they “had their own way, also at looking at certain things” and that they “would want to have the accounts, to feel comfortable, but then they would do their own analysis”. Another auditor remarked that bankers “are good users of financial balance sheets” and that he had seen a shift over the years in the approach of bankers, from a focus on having proper security/guarantees to a more risk based approach that focused on financials. The importance of financial statements for bankers was also highlighted by all three interviewed sole practitioners who explained that financial statements were needed to “support the bank facilities” and to “comply with the terms and conditions of the bank sanction letter”.

Auditors were in agreement that banking institutions, being able to recruit professional people that were “financially literate”, were in a better position to analyse financial statements. However, a number of auditors [3 out of 15] remarked on the “disconnect” that existed between the persons actually analysing financial statements and the branch / credit service line managers actually managing the credit relationship with the client. One auditor even went as far as commenting that “I think they merely tick a box – do we have the financial statements? Yes or No” and that:

“there is a disconnect between people who are looking at the financial statements to understand the business and how it is doing, and the people who are managing the accounts of the business”

This auditor elaborated further on this point by explaining that banks

“have a unit [that analyses financial statements]....my issue with the bank is that then, this is not the same unit that deals with the actual bank account... so there is this dichotomy but they do have people that understand

accounts... Ideally it should be the Branch Manager, whoever is handling the loans that has a better understanding of those accounts”

Shareholders were far less inclined to focus on the use of financial statements by bankers. Two shareholders did mention banks as being users of financial statements, but as one of these shareholders commented “if you need bank financing, you will provide historical, but more importantly, you’re going to need to provide current information and projected information”.

(ii) *To satisfy income tax requirements*

All auditors, directly or indirectly, referred to the use of financial statements by Malta’s Inland Revenue Department. Various references were made to tax obligations, such as that financial statements were “needed to support the tax returns” and that they were needed to “determine realised profits for tax”. In elaborating on this point, auditors invariably referred to the audit function. One auditor commented that the Inland Revenue “wants it [audit] because they have the comfort of audit”. As another auditor opined, “they [Inland Revenue Department] know that we have got a lot at stake, through quality assurance, professional indemnity, reputation risk”. There were again, however, contrasting views on the extent to which the financial statements were actually used by tax assessors – on the one hand, an auditor stated that he doubted “if the Inland Revenue actually reads the auditor’s report to see if it is qualified”, while on the other hand, another auditor opined that “financial statements were the take off point for any tax investigation”.

In answering this question and question six of the interview schedule, a common consideration made by the auditors was that income tax considerations were a “secondary” objective of preparing financial statements. Different words were used to describe the use of financial statements for tax purposes, such as “a by-product of preparing financial statements”, “a secondary use”, “a subsidiary objective of preparing financial statements” and “a derived objective of financial statements”. These views were expressed particularly in the case of small owner-managed companies, where according to one auditor, “at the end of the day, tax, and perhaps the banks, will, in substance,

probably be the main focus of the financial statements”. According to two auditors, the preparation of financial statements also brought about positive effects for the authorities from a tax collection point of view. One auditor stated that “the discipline of preparing financial statements, of having them audited is important, to, at least, in a society like Malta....keep people within a band of reasonableness”. Another auditor remarked that “financial statements...ensure that tax is paid fairly and is collected”. One shareholder related to this view, extending the use of financial statements to “reflect also the stewardship issue as well...Because society is an important stakeholder in general”.

The auditors acknowledged the difference between the accounting profits and the chargeable income for income tax purposes, but as one auditor explained, the financial statements provide the “starting figure” for the purpose of computing the tax payable to the tax authorities. In this respect, financial statements were described as being “a good basis...for assessing the tax liabilities of companies”, the “primary source for computing the tax on profits”, a “start-off point [accounting profit] in the tax computation, with adjustments being done for tax purposes” and “a basis on which to make their [Inland Revenue’s] work”. One auditor described the present situation as one where “there is an unwritten agreement that the basis for taxing organizations are these...financial statements”.

Some shareholders [2 out of 15] also believed that financial statements were used by the tax authorities. One shareholder commented that financial statements were part of “a whole structure for collecting tax” and that they were a “good system for tax purposes, otherwise....if there weren’t financial statements, the taxman would have to do his own job”. Another shareholder described them as a “starting point”, making “plusses and minuses” to arrive at the income to be subject to tax. However, it was only these two shareholders that referred to the income tax authorities as a user of financial statements.

(iii) *Decision-making: to provide resources?*

Another use of financial statements that is particularly advocated by standard-setters is the decision-making function. Auditors [4 out of 15], given their professional background

and familiarity with standards, could easily relate to this theme. Thus, for example, one auditor referred to “capital decisions...shareholders decisions” on whether to “increase their shareholding or decrease it, to monitor their investment, judge sort of how the investment is fairing or doing”. The same argument was made for lenders, who need to “ascertain to what extent they ...can lend more, lend less, call in their facilities”. Another auditor described financial statements as having the potential to “assist them [providers of finance] to make the decision”. However, there were many comments from auditors [7 out of 15] on whether, in practice, financial statements were actually used for decision-making purposes. Some comments made by the auditors are reproduced below:

“To be really honest, I’ve never come across anybody who made a decision based on the financial statements only, as such only, you know, it’s a useful additional piece of information that is available”

“I absolutely cannot see how accounts, prepared four, five or six months after the date [balance sheet date] are useful”

“I think it’s more by way of being informed rather than by way of their taking any particular decision”

“I think it’s a bit foolish to say, listen, I have based my investment decision based on the financial statements on their own”

“I think for decision making, possibly one would be looking more on forward looking information, rather than historical”

“...for decision making one tends to want more future projections, future information rather than historic”

One auditor, whilst making reference to his experiences when dealing with audit clients and shareholders, commented that:

“Do you really think that an investor will be looking at financial statements for decision-making? If he is a trader, decisions are done very quickly, well ahead of the publication of results.... I think standard-setters still imagine that shareholders wait for the annual report to come out, they then read it and then finally they decide. This is wishful thinking...Things don’t work out that way in practice. Decisions are taken in anticipation of results being published”

In answering question four of the interview schedule, one auditor picked on the use of the phrase “making decision about providing resources to the entity”. He commented that in the case of shareholders, financial resources are provided to an entity either in the case of an initial public offering or a fresh issue of shares. He opined that in such cases, an investor putting in “new funds” in a company would be more interested in “looking at budgets for future periods and cash flow projections – which providers of new funds are given access to in the prospectus”. According to this auditor:

“...if we look at the secondary market for shares, investors buying in and out of a company, are not really providing resources... for investors buying second-hand, so to say, shares, this does not really apply. It could perhaps apply to lenders, but again, lenders will also want projections”

Shareholders [6 out of 15] also downplayed the importance given by standard-setters to the use of financial statements for decision-making purposes. Financial statements were again described as “part of the jigsaw” or “a component” but not as “the sole tool... sole document which any user should rely on”. In fact, one shareholder commented that:

“No one really awaits this [publication of financial statements] to make decisions, to provide financing or when you say resources... No one is presented just a set of historical financial statements and makes a decision to invest. No one does this at all”

and another shareholder remarked that:

“...this is wishful thinking... because what you said here is in a manner that is useful for users. What users are we talking about here? ...I mean if I am an investor and I am not a very sophisticated investor, how do you want me to get through all the information and take a calculative decision. An informed decision based on information which I can't comprehend. Now I am saying this, I consider myself as a person who is knowledgeable on the subject, but sometimes it is ridiculously too deep, too technical in certain aspects, in certain industries which you have to be nearly an expert from an accounting point of view in that particular sector to really comprehend the information being presented”

The responses of auditors and shareholders have therefore made decision making appear less important than what standard setters believe. If someone is going to provide resources to an entity, financial statements will be looked at, but other forward looking information and external factors will be given a higher weighting in the decision-making process.

(iv) *Predicting the future?*

In answering the question on the use of financial statements, reference was also made to the use of financial statements by certain user groups, such as analysts to predict future performance. In certain cases, when this point was hinted at, the interviewer referred to question seven in the interview schedule, which asked interviews to share their views on whether financial statements were useful to predict an entity's future cash flows.

All auditors were adamant that financial statements should not be used to predict the future. Despite the inclusion of information in certain notes to the accounts that may shed light on a company's future performance, auditors were very wary of users seeking to use financial statements to anticipate the future. One auditor remarked today's financial statements go into "loads of projections and all sorts of fantasy interpretations of what's going to happen in the future" but that "historics are the only thing that you can really tie to". At best, auditors stated that financial statements could be used as "a good place to start, but you cannot stop there". In this respect, two auditors described financial statements as being "not completely worthless", "not useless, but they're not very useful" and "they are not very useful, although they are not useless". Various terms were used to describe financial statements in this regard, such as being "some insight into the future", "an inkling in the future", "one ingredient of which I would take in looking at the future", "[being] only a part of the jigsaw" and having "a partial role to play in assessing the future". In fact, one auditor commented that:

"The financial statements say very little about the future. To think about the future, one should consider other factors, such as the future economic climate, competition, technological developments, demographic changes, societal changes....there are so many things to consider, but financial statements say very little about these things"

The main reasons cited by auditors for not relying on financial statements to project the future were that financial statements were “historic” and “not forward looking”, and that the business world was characterized by ongoing changes as a result of external factors within the environment in which a company operated. In fact, three auditors stated that the only situation where financial statements could possibly be used to try and predict the future was in the case of companies operating in “stable environments” or “conservative industries”. Examples cited included companies operating in mature long-term rentals, stable markets such as food products, and importers selling standard goods at standard margins. Otherwise, according to one auditor, “despite disclosures made on future, they’re not reflected, there are no projections, there are no scenarios, there are no sensitivities or stress testing of the balance sheet”.

Shareholders were also skeptical on the use of financial statements to predict the future, albeit that according to some shareholders [3 out of 15], they have a greater value in this regard than that attributed by auditors. For example, one shareholder commented that financial statements:

“show the potential of the company in terms of continuing to perform in the same lines, that it has been performing over the years or whether there is potential for the company to grow....you look at the past to have a little bit of guidance of what can happen in the future.... but in terms of the future, I think there could be an improvement”

while another shareholder described financial statements as:

“an important tool to gauge the past year and compare to the trend of the past three, four years, but also, it could be an indication of what could happen next year”

Other shareholders did not consider financial statements as being useful to predict the future. One shareholder commented that:

“Generally, I believe it's really difficult to predict the future especially in a fast-changing world, international developments on a daily basis. I mean the United States, President Trump who is also unpredictable, what's going on now in Korea and the Far East ... many things are going on around us...”

Another shareholder admitted that financial statements were today taking a direction towards giving some form of “direction” or “some type of guidance for the future”, particularly with respect to the disclosures and commentaries included therein. However, he cautioned that the “excessive use...or abuse of use of financial statements to anticipate the future, has to be taken with caution.” He stated that:

“It is like... I am going to be a little bit blunt, how can you sort of anticipate fashion with today's standards in the future? Things change. The environment around us changes. Organisations, requirements change. Now how fast and how slow is all very dependent on a number of circumstances”

Therefore, auditors and shareholders have expressed serious reservations on the extent to which financial statements can be used to predict the future. It was only a few shareholders that believed that financial statements could be useful in this regard, albeit with certain limitations.

(v) *Financial statements – not the only source of information*

One common theme that has emerged in the responses given by auditors is that financial statements were not the only source of information that was referred to by a user. There were various terms or phrases that were used by the interviewed auditors to describe financial statements, such as “one element”, “an important part of the jigsaw”, “supplementary to other information that is often not contained in financial statements”, “the minimum requirements”, “only one component”, “only one, only one I repeat, of the tools for their investment decisions”, “a base for building models”, “a good start”, “a starting point” and “a benchmark”. The argument made by all auditors was that there were many other factors and sources of information that one needed to look at. In fact, one auditor described financial statements as “not the only source of information when deciding, but it is an important part of the jigsaw”. Other comments made by auditors on these lines included the following:

“...they [financial statements] are not the only thing that an investor has to look at or the only thing that a lender has to look at. But they are for sure useful in making investing or lending decisions”

“...again, not on their own. They [investors] need to know the project and the background, that the company is growing”

“They [brokers] would also communicate with the directors, with the board as well...which suggests that the financial statements are not sufficient in themselves to help users make decisions”

“...they [investors] are not relying purely on financial statements”

“Analysts are there, and they’re analysts because they analyse all information that they can lay their hands on, and that is not all found in shareholder financial statements”

Shareholders were likewise in agreement that financial statements did not contain all the information which they considered relevant to them. As one shareholder described it, “you have to look more deeply into other things, not simply the audited financial statements”. In fact, in some cases, some shareholders started recommending what information should be included in the financial statements, coming up with a “wish list” of information that addressed question eighteen of the interview schedule (see Section 6.4.4.8). Shareholders repeatedly stressed that “there’s not enough [information]” in financial statements and that there were “many other factors...like you get a new CEO, you get a new President...” that were relevant but did not feature in financial statements. One shareholder remarked that companies “don’t operate in a vacuum” and that it was therefore important to consider the impact of external factors. Another shareholder highlighted the strong impact of the media, commenting that:

“...today, media dominates anything, I mean even if the financial statements could indicate that it's doing well, if the markets interpret or the media interprets it in the wrong way, or somebody wants to...interpret it in that particular way, then obviously it will skew an effect, the share price or the bond price in a negative way... so technically speaking we can talk about theory and what should be done and evaluations until we are blue in the face. But in actual fact it's the way how the markets interpret or the media”

Another shareholder critically assessed the present situation by explaining that in his opinion, a “dilemma” existed. The current set of financial statements resulted in an information overload to the reader. Yet, at the same time, more information was needed and so, according to this shareholder, the question was “Where do we stop?” He commented that:

“...there’s information overload in financial statements, and, this information overload is still not enough then, because basically the information you can extend to more more information, so the result is not satisfactory for the user, the original user of financial statements. And there’s also not enough for the seasoned and for the professional investor, who needs more information”

One shareholder was critical of the importance which financial statements were given, particularly by the accounting and auditing profession, stressing that in his opinion, whilst being relevant to the decision making process, they were only one tool that was used. He commented that

“I think accountants and auditors have overplayed the importance of financial statements. They consider them to be the one and all of everything...sort of, like being the fulcrum of everything, or the world going round them. In reality, it is not the case....there’s much more to it...Perhaps they have a self interest, and that is why they try and depict financial statements as being the key to everything”

Auditors and shareholders therefore considered financial statements as being a source of information, but that there was a multitude of information that was relevant to shareholders which did not feature in financial statements. As one shareholder remarked, “financial statements are *a* [emphasis added] source of information, not *the* [emphasis added] source of information”.

6.4.4.3 FINANCIAL STATEMENTS – A GAUGE OF STEWARDSHIP? (Q5, Q11)

The stewardship concept was referred to by auditors in answering the question related to the objective of financial statements (see Section 6.4.4.1). In question five of the interview schedule, respondents were asked to explain what they understood by the term “stewardship” and they were asked to give their opinion on how well the financial statements reflected management’s stewardship. In answering this question, some of the interviewees made points that were relevant to question eleven of the interview schedule, and accordingly, in some occasions, the interviewer cross-referred to this question during the semi-structured interview.

Different definitions of stewardship were given by auditors. However, one common theme in the definitions was the element of “trust” wherein shareholders, as owners, were entrusting their assets to directors for them to be managed in the shareholders’ best interest. Some of the definitions of stewardship that were given by auditors included the following:

“...you have owners and managers of a company, so the managers and directors kind of prepare the financial statements and report to the shareholders. So that is how stewardship comes in”

“the concept of stewardship is one that emphasises the need for someone to care for the assets and resources of an entity in the best possible way “

“I understand that I’ve trusted somebody, I’ve invested money and I’ve trusted somebody to operate this money on my behalf”

“the way I see it is that management is entrusted with the role and they need to report on their performance”

“Stewardship is someone who is taking care to the best of his ability and obviously in a correct and legal manner, the assets and the business of that company. So someone who will do his best to get the most out of those assets”

The shareholders' definition of stewardship was broadly in agreement with the auditors', albeit that some shareholders added certain attributes to the stewardship function. For example, one shareholder remarked that "stewardship, in my opinion, is really directing, strategy" and that stewardship involved "directing a company towards a business strategy". Other shareholders [5 out of 15] expected management to use the assets of the company in the "best" possible way for their interest as owners. Certain words that were used, such as "maximize", "best possible way" and "optimize" indicated that shareholders expected management to utilize company assets as efficiently and effectively as possible. Three shareholders commented that:

"Good stewardship would involve the directors ensuring that the company utilises those assets for the benefit of the company and ultimately the shareholders"

"...have to be responsible for using those funds in the best possible way"

"Stewardship requires the optimization of the use of company assets...optimize, not satisfy or repeat last year's performance, and reporting this to shareholders. Now whether this actually happens in practice is another matter"

Auditors expressed mixed views on the extent to which financial statements could be used as a reflection or measure of management's stewardship. The interviewed auditors [10 out of 15] were in agreement that financial statements showed the results, in financial terms, of management's decisions over a reporting. However, as one auditor remarked:

"they [financial statements] do reflect to some degree the stewardship ... the beauty of numbers is that they get it right, as opposed to qualitative characteristics as well. A very good manager has a very strong management team. But financial statements crudely measure all those qualities and aspects into numbers and measure performance"

Three auditors opined that financial statements only reflected management stewardship "to a limited extent" and that "it is not an entire measure, but one measure of performance". Different examples were cited. One example was in the case of a new venture, where the profit and loss account in the initial years may show losses – on its own, however, this could not be interpreted as a sign of poor stewardship. Another

auditor cited developing markets and telecom companies as examples where financial statements could only be used to a limited extent in assessing stewardship. To illustrate the point, this auditor contrasted such companies with an established business running a stable supermarket operation where profitability was less volatile. Two other auditors gave examples to illustrate the point that financial statements were more concerned about truth and fairness rather than stewardship. One auditor talked about a property company that owned a portfolio of properties that were being rented at below market rates. In such circumstances, the financial statements would reflect the rental income earned by the company, and would therefore be “true and fair” (having been prepared in accordance with the applicable accounting framework), but they would not be indicative of whether better rental streams could be generated. Another auditor used a mining company as an example, explaining that the financial performance of the company depended on factors that were not reflected in the financial statements, such as the quality of the terrain and the equipment it used. Another auditor commented that

“There is no reference in the financial statements about the health of the internal control structures, about value for money. If money was used properly and adequately, about value for money, value efficiency and effectiveness. They only reflect the actual transactions made. So if the company’s sales are 100, and we incurred costs of 70, and our profits are 30, the financial statements are depicting that the bottom line is 30. There is no reference to the fact if the 70 should have been 90. So at least there is a first level of stewardship which is based on actual transactions. But there is no reference or disclosure about controls, about rigour, discipline, ethics of the whole company vis a vis, did we use these assets in the best possible way, again at that particular point in time?”

The reference to “internal controls” or “governance” was also made by another auditor who opined that financial statements were:

“...definitely not an assessment as to whether ...there was good governance or not, and the company was sort of operated in the best interests and reflecting the opportunities that there were in the economy, or not. I mean it’s not an assessment on the governance of the entity, for sure not, on the stewardship function of the entity”

On a similar line of thought, another auditor remarked that:

“Growth in a downturn or growth in a boom is completely different. So sometimes you can grow by two percent and it's a fantastic result, or you can grow by 20 percent and it's not good, why? Because the market has grown by 50 per cent... So, it would be impossible to report on an annual basis on performance without understanding the economic environment that the company operated in at that time”

The point that auditors [12 out of 15] made was that financial statements could not be used in isolation. Moreover, it was important to keep in view the existence of unrealised gains and/or losses that very often were not a reflection of management's performance. Thus, according to one auditor, “revaluation accounting does not help stewardship at all” because there are “unrealized gains and losses flying around [in financial statements] through circumstances that are completely outside of your [management's] control”. One auditor was categorical in advising that “accounts do not go into economy or efficiency or effectiveness in any way” and another auditor stated that financial statements cannot “give us any proper indication or holistic or indication of the stewardship of the company”. Another auditor remarked that “we have had, ample examples, where the stewardship was not what it should have been and the financial statements are several hundreds of pages long” and that therefore, there was no “direct relationship between one [stewardship] and the other [financial statements]”. To illustrate this point, this auditor cited the example of the financial statements of Enron that were probably in line with the requirements of accounting standards but that were “sailing very close to the wind”. Another reason that was referred to by auditors was the many areas of estimation and subjectivity involved in the preparation of financial statements that could skew performance one way or the other, thereby effecting the assessment of management's stewardship. As one auditor concluded, “no one is reporting if the most efficient procurement process was adopted, if management...did a proper tender evaluation processes....The financial statements are only reporting the actual transactions entered into, full stop.”

Shareholders were, however, more inclined to refer to financial statements as a benchmark on which to assess management's performance. One shareholder commented that financial statements “always showed the best part of the company” and that the “dirty work in the management accounts” that is discarded when compiling the final financial

statements should also be presented. This shareholder opined that “the auditor should report on the efficiency and effectiveness of the company through the management of the company... they should be clear... I think they should say something”. Another shareholder also placed the responsibility on auditors, stating that:

“I always expected the particular auditors ... to comment on whether they were satisfied with the system itself ... if there is over-employment... If they considered there is over-employment or under-employment or too much bureaucracy or too little control, okay?... but... to, to give this information in an annual report will continue to add more pages to what is already a huge document... But let me tell you, I would rather have some pages on these topics than a lot of pages of technical jargon with figures and things like that”

The call for auditors to comment on efficiency, effectiveness and economy were, however, shot down by auditors. All interviewed auditors agreed that they could not be drawn in such commentaries. One auditor remarked that:

“So let’s say those resources were not used efficiently. That’s what happened, that is what was sold and this is how much it cost. So ok, it should have cost less but that’s how much it cost. I don’t think it’s the auditor’s business to comment upon whether the costs should have been lower, for example”

and another auditor contended that:

“the parameters used to measure the economy efficiency and effect, in fact have nothing to do with the financial statements, nothing at all”

Another auditor described it as an “unreasonable expectation”, pointing out that auditors were increasingly working in a litigious environment and making certain comments or judgement could expose them to litigation, particularly on contentious issues such as the duty the care. To emphasize this point, one auditor concluded that “if we’re expecting the financial statements to be used, to comment about economy, efficiency, to my mind you’re using the wrong tool.”

Another shareholder stressed the importance of making inter-firm comparisons when assessing performance, therefore comparing financial results with those of competitors in

the industry. In fact, this shareholder explained that in his opinion, financial statements had a deficiency in this respect, since they did not include comparisons with similar companies, an aspect that is fundamental in order to make a fair assessment of performance. Financial statements did not “give details of management decisions which could have resulted in greater profits” and therefore they could not be used to assess the management of the company’s assets. This point was also made by one auditor who remarked that “management’s lack of initiative and efficiencies....were unlikely to filter to financial statements” and therefore “supplementary data was needed”. According to shareholders, this supplementary data should take the form of management information (such as budgets and key performance indicators), ratios and comparisons with industry peers.

Another shareholder cautioned about the effect of one-off events or transactions in assessing performance because:

“I could single handedly have a one-off entry, a one-off line item, which could affect in a radical way the performance of a reporting entity for a particular year, either to show it in a positive light or to show it in a negative light”

The short term versus long term view of financial statements was also touched upon by shareholders in answering this question. Shareholders [3 out of 15] agreed that financial statements could only provide some of the information that was needed in assessing short-term performance. As one shareholder remarked, “in the long run, we are all dead”, and “in terms of the long term, there are so many factors that ...can hit the company, one way or the other” that it would be “guesswork” to use financial statements as a basis of assessing performance. Moreover, the fact that a company had done well in the past did not imply that it would continue to do so in the future.

6.4.4.4 THE UNDERSTANDABILITY OF FINANCIAL STATEMENTS (Q8, Q13, Q14, Q16, Q17)

In question eight, the interviewees were asked about the extent to which they considered that the information contained in financial statements was being understood by users, and whether this information was actively being used.

All interviewed auditors categorically stated that in their opinion, the message of financial statements was not being understood by shareholders. The common theme was the “need for simplification”, particularly for users that were not financially literate who would get “lost” in trying to understand financial statements. According to one auditor, standard setters have issued standards that “try to measure things in a way that’s very clever” but “at the risk that no-one understands what is happening”. One auditor described the standard setting process as a “white elephant” and one that had “gone overboard to a very, very great extent”, therefore advocating a return to “bread and butter accounting” or a “back-to-basics approach”. Two auditors remarked that understanding financial statements today required specialists; in fact, these auditors commented that “a specialized financial reporting person, not just an accountant” was needed to understand financial statements and that “it is not going to be the man in the street, it has to be a trained, experienced professional to be able to [understand], it’s a trained professional”. Another auditor pointed out that the accountant’s role ended up in trying to find a way of “how am I going to simplify and explain this in layman’s terms”. In fact, according to another auditor, a “translator” was actually needed to order to “translate the financial statements in simple terms”. Some relevant comments in this regard included the following:

“They [financial statements] should be conveying a message which is more understandable to the wider public; trying to complicate life and trying to be too clever, not only in disclosure but even in measurement, I think at the end of the day it comes back to haunt you and to bite you”

“...they need the explanation. On their own, they won’t really be understanding and they would appreciate when you say go in and explain it to them part by part, going through the profit and loss and therefore going through the balance sheet and explaining it to them”

“...the financial statements are not for a layman”

“...if the user is not an accountant with certain technical background, they struggle to understand the financial statements unless someone explains or you know ...you need a translator sort of... you need someone interpreting what is being disclosed in layman terms”

“Without that [explanation], you are giving them a document which for them is Chinese”

“...the communication of important financial information I think needed simplification”

“During an audit, when going through financial statements to ensure all disclosures are included, sometimes the joke within the audit team is that no one would actually be going through all this detail, except for us! No one would notice a missing disclosure and people just skim through them”

Whilst auditors were in agreement that the understandability of financial statements was an issue for the layman, some auditors [4 out of 15] even considered this to be a problem for other persons that may have a basic knowledge of accounting. One auditor expounded on this point by claiming that:

“a lot of accountants today, who have moved out of public practice or maybe are small firm practitioners, if you give them a set of financial statements of a bank or something like that, you know, they will just start flicking through the pages”

Two other auditors made similar observations, advising that the understandability of financial statements was not an issue for lay people, but it had also become a problem for accountants who were not IFRS specialists. One auditor questioned whether financial statements were actually being understood by bankers and even by the regulators themselves.

All shareholders expressed even stronger views when answering this question. They were vociferous in claiming that “only a few... really understood the financial statements” and that “financial statements are not simplified enough for me to understand and use”. The communication aspects also featured prominently in the responses given – one shareholder remarked that information “is not communicated in a way that the retail investor understands” and that therefore, “some... information is there, but unfortunately, I don’t know, have the knowhow to understand them, how to read them, how to look for them”. One shareholder opined that over time, the utility of financial statements was diminishing because users were understanding “accounts less and less” and were

therefore discarding them as being “irrelevant”. One shareholder summed it all up by asking a series of questions as follows:

“Is the message getting through? Are the people who are reading these documents really understanding what's going on? Can they link the dots? Can they take a judgemental decision on whether they should further their investment or not at the end of the day? Are there concerns that their objectives are really being observed?”

In the light of the current situation, most shareholders [8 out of 15] agreed that stockbrokers had a particularly important role to play. One shareholder remarked that he “normally trusted my account manager [stock-broker]” since “I don’t do any research myself on what is going round in financial circles...and therefore I normally take the advice of the broker”. Another shareholder commented that “stock-brokers actually carry a lot of responsibility...[since]...most just follow what the stockbroker recommends.” According to another shareholder, the stock-broker had a pivotal role because “I normally trust my broker so I don’t give it [financial statements] the attention probably it should.”

The main factors identified by the interviewed auditors and shareholders as contributing to the lack of understandability of financial statements are described below. All these factors were referred to by the two respondent groups, albeit to different extents. The factors were elicited from the responses given by the respondent groups to questions sixteen and seventeen. The former asked the interviewees whether they considered that the message of financial statements was being understood by users in Malta, while the latter required the respondents to identify those factors that could distort the message being communicated in financial statements to Maltese shareholders.

(i) *Complexity*

The complexity of financial statements was identified as the primary factor that was hindering the understandability of financial statements. Various terms were used by auditors and shareholders to describe financial statements, such as “complex”, “complicated” and “elaborated”. According to one auditor, financial statements had become complicated to a level where even accountants sometimes struggled to

understand them. This added complexity tended to obfuscate the reality of the entity's financial performance and position and was therefore of concern. Another auditor referred to the significant amount of resources (in terms of staff time, effort and cost) dedicated to deal with all these complexities, which were not, however, necessitated by the users of the financial statements. There was the risk therefore that a user "may lose the wood for the trees", getting lost in all the detailed disclosures. Shareholders, likewise, expressed their concern at the complexities inherent in financial statements. One shareholder opined that not all users had the privilege to study accountancy and so financial statements were not readable or usable to such a category of shareholders. Financial statements were described as "extremely complex", "detailed books" and "an overkill". Some areas of complexity were identified by shareholders, such as deferred tax and valuations. In citing deferred tax as an example, one shareholder admitted he never understood the difference between corporate tax and deferred tax.

Different examples were given by auditors of accounting treatments that were creating complexity in financial statements, such as the discounting and unwinding of cash flows, the use of fair value accounting and accounting for financial instruments. One auditor even went further as to refer to basic accounting principles such as the difference between profit and cash, and the difference between realised and unrealised profits, which according to his practical experience, were very much misunderstood by shareholders, particularly in the context of dividend distributions.

(ii) *Frequent changes*

A lack of stability in accounting standards was identified as contributing to problems in understanding financial statements. Both shareholders and auditors were in agreement with this, with auditors expressing stronger views since they were the ones most affected by the repetitive changes in standards in the process of preparing financial statements for their client companies. One auditor made reference to a renowned quote from Heraclitus, a Greek philosopher, known for his doctrine of change being central to the universe, stating that:

"It is true that they say that the only thing that is constant is change, but now we have really gone overboard."

Accounting standards are all the time changing. No sooner is a standard revised that further revisions start to be contemplated. This shows a lack of thinking upfront. This hinders understandability of financial statements. There are too many changes going on”

Auditors, being technically versatile with accounting standards could readily cite practical examples to illustrate their point. One auditor referred to the accounting standard on insurance contracts, commenting that “the implementation date keeps moving every year”, thereby suggesting that “it was an invention and [that] they don’t know where they are going and they begin to find a problem”. Another auditor referred to the accounting standard on financial instruments, which was being “issued in parts...first we had the assets, then the liabilities, and then we went back to the financial assets”, commenting that such an approach “does not show direction” and that coupled with a delayed implementation, would mislead the preparers and users of financial statements. Yet another auditor referred to the conceptual framework that was being revised in phases that were “taking very long to be concluded”. Various terms, evidence of tough criticism, were used by auditors in their responses. For example, words such as “ridiculous”, “absurd” and “farcical” were used to describe the present situation. Another auditor cynically referred to “Which one, which format? I have so many formats...It has been changing so many times...which version?” One auditor highlighted the need for “a stable platform”, in the interests of all stakeholders.

Similar views were expressed by shareholders. One shareholder having an accounting background admitted that accounting standards “were changing so rapidly that people in the profession, or people like me, who once worked in the profession, cannot cope”. This shareholder drew a parallelism between accounting and religion, opining that:

“In my view, accounts are like religion; changes should occur, like any religion, religion develops. But you cannot have a religion that changes every year because you lose track of what the religion is...changes are happening too often for anyone to follow”

The frequent changes in accounting standards was also, according to one shareholder, distorting the message of financial statements because “sometimes it is one way, sometimes it is the other, then it’s another” and such “continuous change does not

contribute to the validity of financial statements at all”. One shareholder expressed his view that standards were changing to try and give out more information to the user, but that in so doing, the user was “getting lost in words and changes”. This shareholder advocated that “less changes would contribute to understandability, especially when changes are done only for the sake of changing”.

(iii) *Information overload*

All interviewed auditors and shareholders were in agreement that the financial statements currently resulted in a situation where the reader was exposed to too much information. The term “information overload” was mentioned by two auditors and two shareholders. Other interviewees, however, made various comments that were indicative of such a situation. For example, terms or phrases used by auditors to describe financial statements included the following: “a 120, 130 page set of financial statements which no one reads”, “it’s overdone in many cases”, “pages and pages of notes”, “you have 50 or 60 pages... it is not a fiction that you will read”, “they run into a couple of hundred pages, it’s unacceptable to me”, “a lot of granular detail in the financial statements that you get lost” and “quite voluminous, detailed and difficult to draw conclusions”. Shareholders likewise described financial statements as a “Bible” that is “so vast” with “many figures tossed around”. Another shareholder commented that usually, the more information the better, but in this case, it was a situation where more information may not actually be better for the reader. In fact, one shareholder stated that he was “very shocked recently to see financial statements that are nearly a hundred and twenty pages. Really!”. One shareholder did not foresee that the situation would improve in the near future given that:

“this volume of information has increased and it seems it will continue to increase and when do we stop. Till they become 500 pages long? Then what will be the next step?”

Another shareholder compared financial statements to a restaurant menu, commenting that generally, the longer the menu, the wider the choice for the person dining at a restaurant. However, in this case:

“it’s like you have a very, very long menu when you go to a restaurant. Imagine you go to a restaurant and you have a very short menu, so you can choose... out of ten items it’s

easy to choose and then you go to a restaurant, which has a hundred-page menu. You are happy that there is a bigger choice but it's really more complex and you don't know whether you've really decided or taken the meal that you really wanted"

One other shareholder made an interesting comment on the information overload factor, opining that the current situation was neither beneficial for the "normal" investor nor for the "professional investor". This is because:

"I think that there's information overload with financial statements... the result is not satisfactory for the user, the original users of financial statement. And there's also not enough for the seasoned and for the professional investor, who needs more, different information"

It is clear therefore that both respondent groups agreed that financial statements were providing and exposing shareholders with too much information, making it difficult for them to understand the key messages.

(iv) *Technical jargon*

The use of technical jargon of an accounting nature was described as another factor that made it difficult for users to understand the message of financial statements. Auditors and shareholders were generally in agreement on this. Financial statements were described by one auditor as being "ridiculously too deep, too technical in certain aspects". Two auditors cited the insurance and banking industry as specific industries where technical specialized accounting knowledge was needed in order to really comprehend the information presented. One shareholder claimed that accountants were "very eloquent... and they do like to use flowery language" in financial statements. Another shareholder referred to the technical jargon as an "unnecessarily elaborate way of communicating" that was clearly not user-friendly for the users to understand. Another shareholder blamed accountants for using many complicated words or phrases in financial statements in an attempt to be perceived as skilful. This shareholder doubted whether accountants would actually wish to revert to simpler language because "the use of technical jargon gives status to the profession and sustains its monopoly privilege".

(v) *Too many options*

Another factor that was referred to by some auditors [4 out of 15] was the different options available under accounting standards. Examples that were cited included the fair value model and cost model available for accounting for investment property under IAS 40 and companies measuring certain assets at fair value at group level, but then the same assets were measured at cost at the level of the subsidiaries. These different options were described by one auditor as being “a collection of compromises” which were often the result of the need to find compromises between different jurisdictions during the standard setting process.

The main argument made by these auditors was that different options in accounting for the same transactions resulted in different values being included in financial statements. It was therefore a situation where the preparer had a choice to make, between what auditors referred to as the “benchmark treatment” and the “allowed alternative treatment”, which terms are frequently used in accounting standards. One auditor commented that this resulted in a situation where similar transactions were accounted for in a different manner. This auditor acknowledged that the selected option would be duly explained in the accounting policies, and possibly in the notes to the accounts, but he expressed his serious doubts on whether users actually read and understood them. Another auditor acknowledged that the different options were being reduced over time, but he still opined that “there are too many options, too many different ways of accounting for the same transactions”.

Three shareholders also hinted at the different available options, albeit that given their limited technical expertise, they did not specifically refer to different accounting treatments or options. One shareholder referred to the fact that some figures changed from one year to another. Upon further probing by the interviewer, it transpired that he was referring to the restatement of comparatives and prior year adjustments. Another shareholder mentioned in a generic manner some of the different options available, distinguishing between the cost method and the revaluation method. This shareholder opined that giving different options inhibits the users’ understanding of financial

statements because “one asset is shown one way in a set of financial statements, and a similar asset is shown another way in another set”. One other shareholder pointed out that he was aware of the existence of different options available, having some accounting background, but that these options “were too technical and therefore beyond me”. Still, he did not consider them conducive to the users’ understanding of financial statements.

(vi) *Volatility in earnings*

The volatility in reported earnings created by the use of fair value accounting was mentioned by auditors [5 out of 15] as impacting on the users’ understanding of financial statements. This point came out very clearly when auditors were answering questions thirteen and fourteen of the interview schedule. The findings of these questions are presented in Sections 6.4.4.5 and 6.4.4.6. In general, the comment made by auditors was that fair value accounting had resulted in various fair value movements being accounted for in the profit and loss account, and this had therefore resulted in a situation where the reader could no longer make a distinction between the profit/loss on operations and that on other activities, thereby affecting the users’ understanding of financial statements.

(vii) *Financial illiteracy*

The interviewed auditors [10 out of 15] were particularly concerned at the low level of financial literacy prevalent in Malta. These auditors agreed that shareholders had little knowledge of accounting, but some of the auditors also extended this limited knowledge to journalists and at times, bankers. One auditor expressed his surprise at “how little knowledge journalists have of financial statements, often picking up the wrong results”. Another auditor described shareholders as “financially illiterate”, referring in particular to some categories of shareholders like pensioners or other persons investing surplus cash for the purpose of earning a dividend stream. This auditor remarked that such shareholders could not understand financial statements because they were not trained to understand financial statements. Another auditor was careful to describe such shareholders as “financial reporting illiterate” or “IFRS illiterate” emphasizing that such shareholders would generally have basic financial acumen, but that this was not enough

to comprehend today's complex financial statements. One auditor remarked that in his opinion, the profession should take a bigger lead in educating the readers, particularly financial journalists or analysts who report the message of financial statements.

Shareholders [9 out of 15] also admitted that they believed that the level of financial education was a stumbling block in the process of understanding financial statements. In fact, one shareholder admitted that shareholders depended very much on “what they know or hear, and what they read in the media about companies” while three other shareholders confirmed their reliance on their stock-broker. One shareholder believed that the financial statements included useful information, stating that “it [information] is there, it is there to read, but we don't have the knowledge to understand it”. A need to educate the public was therefore a common line of thought advocated by five shareholders. Different authorities were cited as entities that could fulfill this role, such as the Malta Stock Exchange, the Malta Financial Services Authority, the College of Stockbrokers and the listed companies themselves. According to one shareholder, companies “should not leave things up to the shareholders”, but they should take the initiative to explain the financial statements to them, and “not wait for the Annual General Meeting”. Another shareholder, however, was of the opinion that the financial illiteracy was an excuse used by the accounting profession to justify the present situation. He believed that the profession “should not put the blame on the users”, arguing that:

“you don't go to the doctor and tell him, please educate your client. The doctor has to talk in simple terms to the client, such that the client can understand”.

6.4.4.5 THE ASSETS AND LIABILITIES APPROACH TO FINANCIAL STATEMENTS (Q12)

Question twelve of the interview schedule asked respondents to comment on the move from the “income and expenditure view” of financial statements to the “assets and liabilities approach”.

The interviewed auditors expressed mixed views on the shift that there has been over the years, from the income and expenditure view to the assets and liabilities approach in preparing financial statements. Different auditors [7 out of 15] gave different positive

attributes to the assets and liabilities approach, describing it as “making a lot of sense...in theory and in practice” and providing “more insight on the value of the business” and “a more accurate picture of the financial health of the company at a point in time”. However, auditors [6 out of 15] also cautioned about the implications of using this approach. In particular, five auditors referred to the increased volatility resulting from the use of fair values to measure assets and liabilities. One auditor argued that the current decrease in interest rates was pushing up fair values, and he questioned whether businesses were actually better off as a result of this. Another auditor cautioned that one needed to be careful because there was the risk that movements in the valuation of assets and/or liabilities were “blurring the stewardship element”. This is because an entity may have performed poorly from an operational point of view but still end up showing a positive bottom line in view of fair value movements recorded in the income statement. This auditor was of the opinion that shareholders would not be able to decipher this. Another point made by another auditor was the extent of subjectivity that was prevalent in valuations which could result in significant volatility “just by changing slightly the discount rate used in a valuation model”. This auditor also mentioned the difficulty in valuing certain assets, particularly in a small country such as Malta, where markets may not be very active and where accordingly the market price may not necessarily reflect fair value.

In answering this question, two auditors explained that their answer was dependent on the identification of the users of the financial statements. One auditor commented that if the users of financial statements are the “normal” Maltese investors, the banks and the Inland Revenue, then he was of the opinion that the shift to the assets and liabilities approach had “complicated matters, not for their benefit, but to their detriment”. This was because the financial statements had become overly complicated for these users. Another auditor stated that in his opinion, the assets and liability approach was suitable for the sophisticated users but not for the vast majority of shareholders in Malta.

Shareholders [6 out of 15], although not very technical on the subject, were more inclined to favour the asset and liability approach, albeit on the premise of their being a clear distinction between the operational profitability and other fair value movements. One

shareholder remarked that the assets and liability approach reflected the economic cycle of the business environment. He therefore commented that the introduction of volatility in earnings reflected the environment that companies were working in. However, he advocated that the income statement should clearly distinguish between the two. This view was echoed by three other shareholders, who stated that fair value movements should not distort the operational results. One of these shareholders opined that such movements in valuations are non-cash items that are not distributable in dividends, and should therefore “be shown below the line”.

Other phrases that were used to positively describe the assets and liability approach included the following: “gives a better balance sheet position”, “a better snapshot of the company’s strength” and “it gives more up to date figures”. One shareholder commented that the use of fair values to value assets such as immovable property helped the reader to better understand the balance sheet since “these are tangible values one can understand”.

6.4.4.6 THE USE OF FAIR VALUE ACCOUNTING (Q13)

Question thirteen asked respondents to comment on the increased focus of fair values and mark-to-market accounting in the preparation of financial statements as opposed to historical cost accounting.

The majority of auditors [9 out of 15] favoured the increased use of fair values. However, they were all concerned with the extent to which fair value accounting was being used. Their concern was manifested by the use of certain terms such as “it’s being taken to an extreme”, “it’s dangerous”, “we have gone too far”, “it has gone overboard”, “it becomes nonsensical” and “we have stretched it to apply to too many assets”.

The general view of these auditors was that the move to fair values was a step in the right direction, but that this had been taken to an extreme. According to one auditor, the situation could be summed up as one where the use of “fair value makes a lot of sense...[but] I think we have messed it all up”. The auditors’ concern on this front was

also evident in the use of certain words that were attributed to the process of ascertaining fair values. For example, one auditor commented that the preparers of financial statements could “try to concoct the fair values”. He also referred to “all the nonsense about level one, level two and level three” in determining fair values. Another auditor was wary of the subjectivity introduced in the process of preparing financial statements, which process is “generally perceived to be one of correctness and accuracy and therefore almost incompatible [with the use of fair values]”. One auditor commented that:

“When it goes into all these sort of complicated options and fair value assumptions which require a 200 page report to establish a value of an investment, which no-one will understand... That is when I start to become uneasy, because a 200 page report can be written in one way or in another”

Three auditors were very much against the use of fair values, citing the complexities in measurement and judgements involved in ascertaining these amounts. One auditor argued that:

“the preparation of financial statements has become nearly a science in my opinion and it requires the use of forecasts... future cash flows and this has brought a lot of subjectivity too”

while another auditor argued that:

“these standards are for big companies, public entities, big companies and so on. You can't impose these standards on small companies, it is a waste of time frankly. I'd rather look at a simple cash flow for a small company and stop at that”

These views were echoed by all three sole practitioners, who explained the difficulty in applying fair value accounting for smaller companies. One of these sole practitioners argued that:

“this fair value method market to market accounting against a historical basis has created much confusion, much scope for abuse, much scope for interpretation because a two percent discount factor here or there can have a very big difference on the fair values of certain assets”

and another sole practitioner stated that:

“fair valuation involves too much speculation...too many judgements...you can inflate profits substantially”

Another auditor commented that:

“I have a nostalgia, the time when...figures were what they were, I mean from an audit point of view obviously it's much more difficult to audit and for preparation and all that”

In view of the problems in ascertaining fair values, five auditors were very much in favour of making a distinction between the larger companies and the smaller ones. In their view, the financial statements of small companies should be based on historical cost accounting, with any relevant fair value information being reported outside the set of financial statements, such as by way of “financial information”. According to these auditors, “if you stuck to the cost model, you will be addressing the needs of the less sophisticated users” and would therefore be addressing the vast majority of users.

The majority of the interviewed shareholders [9 out of 15] had positive comments to make in relation to the use of fair values in preparing financial statements. They described such values as being “more relevant”, “more up to date”, “realistic” and “showing a sensible picture of what was achieved”. One shareholder described fair values as “representing facts in a way that is more reflective of reality”. It was only two shareholders who expressed their serious concerns with the element of estimation and judgement involved in ascertaining fair values.

6.4.4.7 A TRUE AND FAIR VIEW VERSUS PRECISION IN NUMBERS (Q9, Q10)

Question nine of the interview schedule asked the interviewees to explain whether they considered the financial statements to be precise, accurate and correct. The following question (Question ten) then asked respondents to explain their understanding of the phrase “a true and fair view”.

In answering these questions, all auditors acknowledged that financial statements could not be considered to be precise, accurate and correct because of the various judgments and estimation that were involved in the preparation of a set of financial statements. One auditor commented that:

“the measurability aspect... a number is a number, if I sold 10, I sold 10. What can you say ? I sold 9.5 or 11.5? And how much it cost me to sell that 10? It cost me 8, have I sold it for 10? If it cost me 8, then I made a profit of 2. What’s so complicated? But nobody really understands the complications that there are in drawing up a set of financial statements”

This auditor admitted that persons not involved in the preparation of financial statements “perceived numbers to be something precise” and that “one plus one is two... numbers are numbers”. Such users did not understand or were not aware of the level of estimation and judgments involved in the preparation of the financial statements. This view was echoed by other auditors, who referred to the use of fair valuation that “brought in further subjectivity... a lot of subjectivity” in a process which is generally perceived as being one of correctness and accuracy by the users. The perception of figures being “accurate and certified” was also referred to by another auditor who drew a comparison between audited financial statements and documentation received from a bank. This auditor commented that people perceived a high degree of accuracy from documents issued by a bank, given their reputation and also being regulated entities. He commented that such an expectation also applied to audited financial statements given that they were being signed off by the auditor. Another auditor commented that shareholders expected the auditor to give a confirmation that there were no errors in the financial statements, but that “shareholders were wrong in expecting this because this is not a tick box”.

Two shareholders having an accounting background could relate to the views aired by the auditors, admitting that in general, shareholders did not understand that there is “interpretation and judgment in the background”. As a result, the financial statements “were absolute for them” and were considered tantamount to a “Bible”. In fact, one shareholder admitted that he “took the figures as Bible” because they have been audited and because the auditor “gives him the comfort that systems are correct...in several areas”. Another shareholder referred to financial statements being “certified as true and

fair” and that he tended to believe the auditor, especially if the auditor was a Big Four audit firm. Auditors were, however, careful, not to refer to terms such as “certification” or “systems are correct” when answering these questions. In fact, given their professional technical background, auditors were more inclined to refer to the concept of materiality in answering these questions.

One auditor commented that financial statements were meant to “show as close as possible what actually happened”. Another auditor described financial statements as giving “an approximate picture...definitely not precise, definitely not totally correct”, describing it as “the right picture within materiality considerations”. Other terms that were used by auditors to answer this question included the following: “a materially precise, accurate and correct position”, “more or less, they are correct”, “a fair reflection of the company’s assets, liabilities, profit and loss”, “materially precise and accurate”, “pretty accurate”, “materially accurate” and a “realistic position”. In order to elaborate on this point, one auditor made a comparison to drawing a picture as follows:

“Imagine you are drawing a picture, this is a kind of a reasonable resemblance of what we are trying to picture. This is what financial statements try to achieve – a reasonable resemblance of what happened”

In answering this question, three auditors remarked that the concept of truth and fairness needed to be interpreted with reference to a financial reporting framework, and that on its own, it was “meaningless”.

Although the majority of shareholders [8 out of 15] acknowledged the fact that financial statements could not be one hundred per cent precise and correct, it was clear that the level of preciseness which they attributed to financial statements was higher than that of auditors. Words like “a true picture of business operations”, “correct statements”, “no misstatements” or “a certified position” indicated that shareholders expected financial statements to have a high degree of precision. One shareholder described them as “an absolute correct summary of what’s happened” while another shareholder described them as a “very good, almost precise, indication of the company’s performance”. It was only three shareholders having an accounting background that somehow related indirectly to the concept of materiality. One shareholder admitted that he would be “happy with ninety

per cent of the financials representing a true reflection of the business” and that for the larger companies, “a small misstatement of a few thousand Euros is not relevant and does not affect the reader”.

The main reason for the different perception between auditors and shareholders was the assumptions and limitations inherent in the preparation of financial statements. This was mentioned by four auditors and five shareholders. The auditors focused on the assumptions, judgements and interpretation that were involved in the preparation of financial statements. One auditor cited a number of “basic examples” to show the judgements involved, such as deciding on the useful lives of assets and accounting for a provision on receivables. According to this auditor, the preparer of financial statements could “change the numbers of financial statements with slightly different judgements”. Another auditor referred to the discounted cash flows that are used when accounting for assets at fair value, remarking that a slight change in the discount factor could significantly increase or decrease reported values. Another auditor stressed that:

“This is what shareholders should be told about! The judgements, the assumptions involved in preparing a set of financial statements. Numbers are seen as precise. But in reality, preparing a set of financial statements is not a science, but an art”

One auditor expressed his firm view that until users appreciate the limitations of the financial reporting process, the difference perception on financial statements between the users and the preparers of financial statements will continue to exist.

Shareholders did not specifically refer to the judgments made by preparers of financial statements, but they instead acknowledged that they were aware that management could in certain cases “massage numbers” to portray the desired results. One shareholder commented that a company could decide to revalue its assets “if it wanted to look good with its shareholders” while another shareholder believed that management had “leeway on what financial results to present”.

6.4.4.8 IMPROVING THE RELEVANCE OF FINANCIAL STATEMENTS (Q14)

Question fourteen of the interviewed asked the respondents to comment on the extent to which the present format and content of financial statements was adequate to meet the users' requirements. In answering this question, interviewees also gave their insight on what they considered to be relevant information that ought to be included in financial statements, therefore linking to question eighteen of the interview schedule. In fact, this latter question asked participants to explain what specific information they believed investors and other stakeholders would wish to have included in financial statements.

The responses given to these two questions have been grouped under the following sub-headings:

(i) Profitability and dividend return

All auditors agreed that in their view, shareholders were mainly interested in the profitability of the investee company and its dividend distribution. All auditors expressed their view that at the end of day, the shareholders' interest in financial statements was to determine the company's profitability or otherwise, with a view to receiving a dividend on their investment. Any information on profitability and dividends would therefore be looked upon favourably by shareholders. Different phrases or expressions were used to refer to this point. For example, one auditor stated that "people look at the bottom line... the profits... people look at the dividend streams, that is what is important". Another auditor remarked that shareholders are mainly interested in "short term gains" and that therefore, information on profitability and dividends were most relevant to them. This auditor commented that shareholders were not interested in long term growth but their expectation would be "to receive a dividend, at least at a similar level to that of last year".

One auditor clearly explained this point by stating that "this is what shareholders want to see in financial statements... profits and dividends". Another auditor attributed this focus on profitability and dividends to "the selfish mentality of the investors". One auditor commented that:

“Shareholders in the local market ... are interested only in dividends. I go to a lot of AGMs, I think the question on dividends is very pertinent. I think they look at the relationship between dividends and profits”

and another auditor stated:

“there’s only one line which is of interest, or two, one is the profit and the second is the dividend”

As a result, according to the interviewed auditors, shareholders mainly looked for information on profitability and dividends in financial statements. Key numbers that they looked at included the “profit for the year”, “earnings per share” and “dividend per share”. Thus, auditors believed that such information should be clearly presented for the benefit of shareholders. Auditors were, however, in agreement that the complexity of financial statements was making it difficult for shareholders to “trace these numbers”. One auditor commented that:

“sometimes people do not know where to look for this [profit] ... they get lost”

while another auditor commented that:

“The problem is that shareholders want information on profits and dividends...but they find more than one profit figure... there’s the profit for the year, then there is other comprehensive income, then there is total comprehensive income... so they ask, what is the real profit of the company?”

Shareholders (9 out of 15) were also in agreement that information on profits and dividend was important to them. As one shareholder remarked, “a company that does not distribute, even if it’s profitable, is always seen adversely”. Four shareholders confirmed that when receiving a set of financial statements, they mainly looked at the profit and loss account to assess whether the company’s level of profits was higher or lower than that of the previous year, and to assess the dividend yield that they were earning on their investment. One shareholder commented that in his opinion, information on profits and dividend should be clearly highlighted in the financial statements because “that is what shareholders are interested in...the cash element in the form of dividends that are distributed”.

(ii) *Ratios and inter-firm comparisons*

Three auditors opined that the relevance of financial statements for shareholders could improve if they included ratios and comparisons with other competitors in the industry. According to one auditor, there are a “multitude of ratios” or “a pyramid of ratios” that can be derived from financial statements which would help the shareholder analyse the information. This auditor commented that figures in isolation are meaningless and that therefore, ratios should be included in the financial statements. Another auditor explained that this information could be provided in the form of a “dash-board”, “highlights” or as “key-performance indicators”, enabling investors to gauge performance at a glance by comparing results with those of other competitors.

Shareholders referred to such information more frequently in their responses. In fact, five shareholders referred to the inclusion of such information in financial statements. One shareholder remarked that some listed companies included a five year summary of ratios in their annual report. However, according to this shareholder, this was not done consistently by all companies and moreover, different ratios were used, making it difficult to compare ratios of one company with those of another company. Another shareholder commented that ratios of competitors or industry ratios were never included. In fact, this shareholder recommended that “some sort of industry specific indices” should be created so that they could be used as a means of comparing the performance of companies in the same line of business. An example provided by this shareholder was to create an index for banking institutions in Malta. Another shareholder referred to “performance indicators” explaining that such indicators provided a measurable value that demonstrated how effectively a company was achieving its objectives and that such indicators could then be related to those of other companies in the industry.

(iii) *Information on future plans*

Nine auditors agreed that investors would consider information on future plans as being very relevant to them. Whilst acknowledging the difficulty, from an audit point of view, that including such information in financial statements would create, the auditors

admitted that historical financial statements were of little value when compared to information on future plans. Different aspects of future related information were referred to, such as information on “future investment programmes”, “future capital expenditure”, “future large projects”, “future target clients”, “profit estimates”, “forecasts”, “future cash flows” and “projections”. Auditors, however, expressed their concern at having such information included in the financial statements mainly because of the impact on their work and audit opinion. As one auditor stated, “how can I issue an opinion on financial statements that include information on what possibly could happen in the future?”

Another auditor acknowledged that this would represent a major “paradigm change” in financial statements and therefore another set of verification procedures would be required for auditors.

Eight shareholders identified the need for financial statements to include information on the company’s future plans. On similar lines to the auditors, shareholders referred to “future cash flows”, “projections” and “forecasts” as examples of information that would help them assess “where the company is going”. One shareholder remarked that “there was a thirst for information on the future as shareholders were generally kept in the dark”. This shareholder commented that there was a need for information on “what’s in the pipeline, what’s in the future of the company, where it is heading”. Another shareholder commented that:

“a company should give a range of what they should expect in terms of profits for the next financial year, and then every quarter, they should make a statement whether they are meeting those projections or not. Generally, some companies do issue a statement but this is very brief, with no detail whatsoever”

Another shareholder referred to the importance of including information on whether targets set by management had been reached, together with an explanation of the factors that have contributed to the company’s success or failure in reaching targets. As one shareholder explained, shareholders needed:

“information that is forward looking... information on initiatives being undertaken... new markets... new

products...more quasi-internal information... this is what we want”

Another shareholder commented that getting information on “trends on the future” would be useful, albeit that this would need to be prepared in an “abridged version” so as to avoid “exacerbating the problem with the volumes of information being dished out”.

(iv) *Timeliness*

Three shareholders have referred to the timeliness of financial statements as being a factor that merited improvement. One shareholder explained that in decision-making, particularly on investments, “time was of the essence” and therefore he expressed the need for investors to have more timely information. This shareholder explained that there was generally a time lag between the financial year end and the date of issue of financial statements, sometimes taking as much as four months. This shareholder opined that in today’s world, listed companies should have proper systems and internal controls that should enable the compilation of financial statements in a relatively short period of time. The present situation was that financial statements could take up to four months for them to be issued, such that information becomes “outdated” and the shareholder ends up questioning developments since the financial year end. Another shareholder commented that financial statements should not take long to be published, making it incumbent on the regulator to ensure that deadlines are met and encouraging companies to pro-actively publish results as soon as these are finalized.

(v) *More frequent communication*

Two shareholders underlined the need for more frequent communication between listed companies and the shareholders. One shareholder remarked that his experience as an investor in local companies was that companies generally “stuck to the minimum information requirements, communicating with shareholders only once or twice a year”. This shareholder commented that:

“What I really like to see is... more communication with the investing public, but at least every three months. It is an expense, I understand that it is an expense on the company,

but at the end of the day it is the same company that benefits because it will see improvement and more knowledge of their shareholders”

Another shareholder highlighted the importance of regular communication between listed companies and shareholders. According to this shareholder, financial statements were a “communications tool” and that this “tool” should:

“be used more frequently so that shareholders know where the company is heading... this will create better relationships, better understanding... I think it’s very important to communicate”

(vi) *The need for simplification*

Shareholders [12 out of 15] repeatedly referred to the need for simplification in financial statements. Some of the comments made by shareholders in this respect included the following:

“...financial statements are getting longer, losing their value... Maybe today I would say, and I’ve started to do this actually as well, we don’t really look at the financial statements themselves. We sometimes look at the director’s report and look at the information being disclosed there. It’s giving a summary of the information that is contained in the financial statements and sometimes that is enough really”

“I think summarised information is what you need because the financial statements are a chunky document”

“...a much shorter document, which, all right, will have to contain undoubtedly the results, the actual results, but in a very, very abridged way, something like the two or three page documentation”

Three shareholders recommended that the financial statements should be accompanied by “abridged information” written in “plain simple English, avoiding technical jargon” which shareholders could readily relate to. Different shareholders used different terms to explain the form of the summarized information, such as a “synopsis”, a “summary”, a “powerpoint presentation with financial results”, “a dashboard of indicators” and “a synthesis of results”. One shareholder was adamant that very often, “a one page thing

would give more information that is useful to shareholders than all that stuff [financial statements]”. In order to explain the importance of providing easily understandable information, one shareholder drew a parallelism with trekking on mountains as follows:

“simple wording should not be seen as a reflection of a person’s inability to produce flowery language, but simply a means to communicate with the most basic shareholder...You know, when you go trekking in the mountains, you’re only as fast as the slowest person. Financial statements... have to be aimed at the most ‘ignorant’ so that he or she can read them, and understand them”

6.4.4.9 THE SMALL ISLAND PERSPECTIVE (Q15-19)

Question fifteen of the interview schedule asked participants to describe any characteristics of a small island state (such as Malta) that could influence the objective of financial statements. The objective of this question was to elicit the respondents’ view on whether there were any particular factors associated with small economies that could impinge on the objective of financial statements.

Three auditors stated that they did not believe that there were any particular considerations affecting the objective of financial reporting. One auditor stated that “business is business” and that “the objective of financial statement was the same, whether in a small or bigger economy”. Another auditor put forward his view that although being a small economy, Malta had grown into an important financial services centre. This meant that Malta was not “a simple small island state, with some manufacturing, farming, and shipping”; instead, it had managed to attract a number of high profile companies to relocate to Malta. Two shareholders likewise believed that Malta was “no special country in this sense”. One shareholder stated that:

“if you go to any country, UK, France, whatever. You go to any village, it’s the same... small businesses, groceries. It’s totally the same. People who don’t want to disclose etc”

and another shareholder commented that:

“There’s a very good Italian saying, ‘tutto il mondo e paese’, which means that you’re going to find the same

characteristics whether you are in Japan, you're in Germany, Malta, Canada, it'll be the same thing. Or maybe slight variation, but only a slight one"

The other interviewed auditors and shareholders referred to a number of characteristics which they considered could influence the objective of financial statements. These have been grouped under the following headings:

(i) *Politics*

Four auditors have referred to “politics” playing an important role in shaping the objective of financial statements. In explaining this answer, one auditor referred to the public interest entities in Malta, opining that generally, the government owed a significant shareholding, either directly or indirectly, in such entities, even post-privatization. He argued that within this context, given the dominant or significant influence of the main shareholder, there was the risk that “there’s noise in the message which does confuse”. In explain the term “noise”, this auditor referred to the pressures that the government may exert on management for certain decisions to be taken and recorded in the financial statements, particularly in the case of entities that may have a significant impact on the local economy. Another auditor also referred to “internal politics” stating that:

“Given that we are a small country, where business people know each other, I think there is the risk that financial statements of listed companies are prepared with the aim of showing that the expected results have been achieved, somehow. Directors don’t like admitting that targets have not been made”

Two shareholders made reference to fact that “politics are involved in this [preparation of financial statements]”, especially in a small country like Malta where “the preparers, users and third parties are so close to each other....they could all be in one room, and could chum up things”. As a result of this, there was the risk that the figures may be “politically massaged” and that the “objective of financial statements may take the form of communicating the desired financial results”. Another shareholder referred to the shareholding structure of Maltese companies, arguing that even in listed companies, there are often “major shareholders or groups of shareholders that would dominate” the

company and would therefore “just tell them [minority shareholders] what they [main shareholders] think can pass away, and yes, the shareholders accept”.

(ii) *Disclosing the minimum amount of information*

Five auditors referred to Malta’s particular “business culture”, describing Malta as a “southern Mediterranean country” that had made major advancements in financial reporting over the past decades, but that the business community “essentially remained one characterised by the wish to disclose the least information as possible, if at all”. In explaining their answers, these auditors referred to the fact that the majority of Maltese companies were by far owner-managed companies. These companies “are not used to give certain information out there”, and in fact, whenever possible, they would opt to “disclose the bare minimum amount of information”. One auditor even went as far to state that:

“I know of businesses that purposely... have not submitted their accounts with the Registry of Companies... on purpose... is that right, is it wrong? It’s wrong obviously, but from their perspective they are doing the right thing, because they don’t want to give away certain information”

while another auditor stated that:

“...because of the size of the country... there could be the tendency for information in the financial statements not to be as clear as it should whereby somebody may be trying to, either to hide or not disclose through director’s statements, director’s reports what really he has in mind as a director of a company, what’s really happened in there, so he’s trying to hide or he’s trying to portray a better picture because he wants the job”

To illustrate his point, another auditor made reference to the directors’ report of private companies, in particular to the review of business section. According to this auditor, the information in these reports was of a standard nature and was not of any informational value to the reader. This auditor also referred to the audit reporting lag that was prevalent in many Maltese private companies, arguing that this could extend to eight or nine months from the year end. This was proof that the “administrative task of preparing financial statements was not a priority for private business” as “they would rather not publish their

results because of their competitors”. In fact, another auditor referred to the abridged version of financial statements that were filed by private companies, arguing that these abridged versions were a “disservice to potential users” in view of the scant amount of information that was available. This auditor remarked that “not only is the information submitted late, it is also in an abridged format, which is difficult to decipher”. This auditor concluded that the “in reality, the price of limited liability and secrecy is not very expensive”.

The wish to limit the extent of information that was published was, according to three auditors, also prevalent in listed entities. These auditors argued that listed companies made sure that they complied with the “form” of the listing rules rather than with the “spirit” of the listing rules. In practice, this meant that they would disclose “the mandatory information which they were bound to disclose” but that they “would not consider offering more information to the market”. One auditor remarked that this reflected the “philosophy of the country” where it was difficult for persons to “pro-actively communicate information to the market”.

(iii) Education

Two auditors referred to the low level of financial education in Malta, arguing that this also impacted on the objective of financial statements. One auditor argued that in a small economy, it was expected that, given the limited resources available, the country would not have “sufficient depth in analyzing financial statements”. This auditor described financial education as “lacking” and within such context, the users of financial statements could not be expected to “derive the same benefits from them [financial statements] as in larger countries”. Another auditor described Malta’s “financial literacy as very poor”, arguing that this did not contribute to having “an informed base of users making use of financial statements”.

6.5 CONCLUSION

The objective of this Chapter was to explain and describe how the data from the qualitative phase of the study was collected, analysed and interpreted. A total of thirty interviews of a semi-structured nature were conducted with auditors and shareholders. The first part of this Chapter has explained the design of the research instrument, the sample selection process and the process used for the administration of the interviews. The second part of the Chapter then focused on the analysis of the qualitative data collected during the interviews and the presentation of the research findings emanating from the qualitative phase of the study.

This Chapter has further explored the differences between the two respondent groups that were identified in Chapter Five. Findings show that there are fundamental differences in some basic concepts of financial reporting. Thus, for example, whilst auditors believe that financial statements are aimed at providing true and fair information on financial performance and financial position in accordance with the applicable financial reporting framework, shareholders have widened the objective of financial statements even further. There are also different interpretations on the meaning of the term “stewardship”, with each respondent group focusing on different aspects of how financial statements can or cannot fulfill a stewardship role. This Chapter has also presented the factors that were identified by respondents as distorting the message of financial statements. These included complexity, frequent changes, information overload and the use of technical jargon amongst others. It has also outlined the research findings on the small island perspective on the subject.

The next Chapter will discuss both the quantitative and qualitative research findings of the study and it explains how this study has contributed to both knowledge and practice in the area of financial reporting in a small economy, namely Malta.

CHAPTER SEVEN – DISCUSSION ON FINDINGS

7.1 INTRODUCTION

The aim of this Chapter is twofold: first, it discusses the main findings that were presented in the previous two chapters; secondly, it presents the way in which this study has contributed to both knowledge and practice in the subject of accounting.

The discussion in this Chapter is divided into eight sections. Section 7.2 integrates communication theory in the discussion by focusing on the significance of communication in the financial reporting process. Section 7.3 focuses on the characteristics that are conducive to the proper understandability of financial statements. This is followed by Section 7.4 which discusses the research findings in relation to a central theme in financial reporting, namely the objective of financial statements. Section 7.5 subsequently discusses the over-emphasis that there has been on decision-making as the objective of financial statements. Section 7.6 sets out a critical analysis of stewardship as the objective of financial statements, focusing on the imprecision of the term “stewardship” and how different interpretations are given to this term. Section 7.7 considers whether the limitations of financial statements are communicated well-enough, while Section 7.8 focuses on certain characteristics effecting the financial reporting process that are intrinsically related to a small island economy. Finally, Section 7.9 describes the contribution of this study to knowledge and practice.

This Chapter discusses the research findings in the light of the research questions of the study. Table 7.1 shows the link between the sections of this chapter and the research questions set out in Section 1.3.

7.2 The significance of communication in the financial reporting process	Research Question 1 (RQ1): <i>To what extent does a wider expectations gap (i.e. wider than the audit expectations gap) exist in Malta in relation to financial statements?</i>
7.3 Characteristics that are conducive to the understandability of financial statements	
7.4 Blurred objectives: can financial statements be everything to everyone?	Research Question 2 (RQ2): <i>Are external auditors and shareholders in agreement about the objective and the main use of financial statements in Malta?</i>
7.5 An over-emphasis on decision-making?	Research Question 3 (RQ3): <i>Are financial statements being interpreted as being capable of predicting an entity's future cash flows?</i>
7.6 The imprecision of the term “stewardship”	Research Question 4 (RQ4): <i>To what extent do respondents consider financial statements as being reflective of the performance (past and future) of the reporting entity?</i>
7.7 The limitations of financial statements – are these communicated well enough?	Research Question 5 (RQ5): <i>Are the limitations of financial statements communicated well-enough?</i>
7.8 The small island perspective	Research Question 6 (RQ6): <i>Do certain characteristics (e.g. behavioural aspects) of a European small island state such as Malta intrinsically influence the perceptions on the message being conveyed by financial statements?</i>

Table 7.1 – The discussion of findings and the research questions

7.2 THE SIGNIFICANCE OF COMMUNICATION IN THE FINANCIAL REPORTING PROCESS

This study has adopted communication theory as the underlying theoretical framework. Researchers (for example, Parker *et al*, 1989; Andrews and Sigband, 1984) have criticised the profession for neglecting the communication function in financial reporting, resulting in a degree of inaction by the profession over the years with respect to the low readability of financial information. The research findings of this study have shown the importance of communication in the financial reporting process within the Maltese context. Effective communication with the shareholders of a company has been identified as a vital

component of corporate governance (Merkel-Davies and Brennan, 2017; Higson, 2003). In the questionnaire survey, both auditors and shareholders have ranked the communication of financial information as the most significant use of financial statements. This finding was reinforced in the interviews, particularly by the shareholders who repeatedly referred to the communicative dimension of financial statements. According to the interviewed Maltese shareholders, financial reporting was as much about communication as it was about the numbers and other financial data included in the financial statements. Communication has therefore been identified as central to the accounting function, in line with literature (e.g. Littleton and Zimmerman, 1962; Carey, 1965; Littleton, 1953; Merkel-Davies and Brennan, 2017; Lee, 1982; Higson, 2003). However, notwithstanding the importance of communication in the financial reporting process, a communications gap was seen to prevail in Malta. This gap was caused by the lack of understanding by the Maltese shareholders of the financial statements prepared by the reporting entities. The result was that little attention was being devoted by Maltese shareholders to the financial statements.

A lack of understanding exists even at fundamental levels of the process of preparing a set of financial statements. It is a gap that has been recognized by both Maltese auditors and shareholders, and it was evidenced by the responses to several questions, both in the questionnaires and the interview schedule. For example, an overwhelming majority of shareholders who replied to the questionnaire survey believed that financial statements presented an “accurate” and “complete” [emphasis added] picture of the financial performance and financial position of the reporting entity. Furthermore, shareholders agreed that financial statements showed the “accuracy” and “legitimacy” of accounting records [emphasis added]. During the interviews, the responses given confirmed the shareholders’ expectation for a high degree of precision in financial statements. Certain factors, such as the use of estimates and judgments, which are an intrinsic part of the nature of financial reporting, could not be readily related to by shareholders. The overall picture that has emerged is a dismal view regarding the presumed understanding of financial statements, at times even by users having more specialist knowledge than would be available to the individual investor, and who would presumably be using financial statements as an important reference point in the decision making process. Furthermore,

the seriousness of this communications gap is evidenced by the prevalence of the view among respondents that financial statements are not appropriately responsive to the needs of the shareholders – in fact, both auditors and shareholders have identified other information, which is not contained in financial statements, but which would be of relevance to shareholders. During the interviews, both auditors and shareholders have agreed that financial statements only included information that could be quantified in monetary terms and which was presently governed by accounting standards; however, they identified various other sources of information that would be relevant to them, and which were not included in financial statements. In this respect, financial statements were described as being incomplete in providing shareholders with a comprehensive picture on the reporting entity. The communications gap that has been identified in this study applies to the remote communications disseminated by listed companies to shareholders by way of the corporate financial statements; however, the interviewed Maltese auditors have opined that this also applies to communication in financial statements within non-listed companies.

Communications theory splits the communication process into the message, the means of communication and whether the recipient receives the message that was sent. In relation to financial reporting, the message is the directors' message, the means of communications is the financial statements, and the users' understanding shows whether the recipient has received the message that was sent. Information is conveyed to the reader only if the message sent is the same as the message received, and this message is well understood. It is only if the message is correctly interpreted that information can be said to have been transferred.

The message of financial statements is related to the objective of financial statements, and therefore, unless the objective of financial statements is clear, a communications gap is created in situations where the user interpretations may be different from that intended by preparers of financial statements. In this regard, the research findings have shown major issues in the interpretation of the data that is included in financial statements. Various factors have been identified that contribute to “noise” and “distortion” in relation to financial statements. These include the following:

- (i) *Complexity of information* – Maltese auditors and shareholders have opined that financial statements have become unnecessarily complex, and that this situation seemed to be getting worse over the years. Research findings from the questionnaire survey and the interviews complement each other in identifying that complexity exists in two main areas: disclosure (for example, the volume of narrative disclosures on risk management) and measurement (for example, accounting for deferred tax and the use of discounted cash flows). It could be argued that this added complexity is the inevitable result of the complexities in today's modern business environment. Developments in technological, financial markets and complicated organisational structures are some of factors that have resulted in a situation where global markets are demanding more information and details on companies. Furthermore, financial statements are increasingly including complex information in an attempt to try and address investors' / lenders' need for information on future cash flows of the entity. However, it is clear that Maltese auditors and shareholders would welcome a shift to a financial reporting environment that would help the preparers of financial statements to communicate more clearly, in a less complex manner, with shareholders.
- (ii) *Frequent changes* – Maltese auditors and shareholders have expressed concern at the amount and speed of changes in accounting standards. This was particularly evident during the interviews where auditors and shareholders referred to the frequent changes in accounting standards. Whilst it is appreciated that such changes are driven by developments in the market and regulation, it is clear that both respondent groups would welcome a sustained period of stability or a “moratorium” in the accounting standard setting process. This would enable both parties to fully come to terms with the new requirements and thus be in a better position to digest the changes being implemented. In particular, auditors referred to the efforts that they deployed to train themselves to keep abreast of all developments, while shareholders opined that the frequent changes in format, terminology and content inhibited the understandability of financial statements and were also detrimental to the ability of shareholders to make inter-firm comparisons on the basis of financial statements. As one interviewed shareholder

commented, it was difficult for the layman to keep abreast of all these changes and there was therefore the need for stability in accounting standards.

- (iii) *Information overload* – research findings have shown that there is agreement between the respondent groups that financial statements present an information overload to shareholders. The data collected from the two research instruments complements each other in this respect. Thus, for example, both respondent groups in the questionnaire survey agreed that financial statements were “too lengthy and complex to read”. Certain adjectives or terminology used by the interviewees (for example, “so vast”, “granular detail” and “voluminous”) have further reinforced these findings. Over the years, the length of financial statements and associated notes has been on the increase as a result of various new disclosures being included in financial statements, such as additional disclosures on fair values, risk management and going concern (e.g. Deloitte, 2010; IFAC, 2008). Furthermore, accounting policies were singled out by shareholders as including endless pages describing the complex accounting policies and these were hardly ever referred to by shareholders. Apart from the added disclosures, narrative reporting in the form of reports such as corporate governance reports and the Chairman’s report, have further contributed to the information being disseminated to shareholders. The perception of auditors and shareholders in Malta is that this information is simply too much for the shareholders to absorb. They believed that in practice, reporting through financial statements has become more of compliance exercise, where a series of boxes need to be ticked and where the key message is lost in the clutter of words and numbers. Indeed, the research findings of this study corroborate a statement made by the Chairman of the IASB in 2016 that “for the investor, it is often difficult to see the woods through the multitude of information trees” (IASB, 2016b, p.3). It is believed that the situation is one where companies are simply communicating more, not better. A shift to simpler reports highlighting key messages was therefore called for, particularly by Maltese shareholders.

Furthermore, according to Maltese auditors and shareholders, this information overload was driven by the regulatory impositions and accounting requirements as opposed to a wish by the preparers of financial statements to communicate better with shareholders. Listed companies are faced with a situation of trying to serve two masters at the same time – they want to communicate information to shareholders on the performance of the company and at the same time, they need to comply with the ever-increasing regulatory requirements. Achieving both objectives at the same time in the same report has become a challenge.

Indeed, there is the risk that the preparation of financial statements may have become an end in itself, rather than a means to an end. The preparers of financial statements may be faced with a situation where the present accounting and regulatory requirements are stifling the possibility of describing what a business actually does, and instead the focus is on the technicalities involved in preparing financial statements. In other words, the existing complex rules may be resulting in a situation where preparers of financial statements are reporting less relevant information in more detail simply to comply with the applicable rules.

- (iv) *Technical jargon* – the use of excessively technical jargon was referred to by auditors and shareholders as inhibiting clear communication of the message included in financial statements. Research findings show that financial statements presently include over-technical or legalistic language that is difficult for shareholders to discern. Maltese auditors and shareholders agreed that the issue was not one of language (that is, using the Maltese or English language). Although English is a second language for Maltese citizens, the use of English in the business world is widespread and one may indeed consider it to be the primary language of business in Malta. The failure by preparers to use plain English in financial statements therefore created another barrier to the understandability of financial statements. The interviewed shareholders were particularly critical of the use of excessively technical terms in financial statements, describing accountants and auditors as being eloquent in the use of “flowery language” in order to unnecessarily complicate matters. Some shareholders also referred to the

possible self-interest that the accountancy profession may have in retaining the status quo, arguing that the use of technical jargon supported the status of the profession in society. Shareholders were therefore critical of the profession's inclination to limit the use of technical jargon, in line with Power's (1999, p.30) claim that "a certain obscurity in the professional craft gives the practice its aura and sustains its monopoly privilege".

- (v) *Different alternatives of accounting for similar transactions* – Maltese auditors and shareholders agreed on the need to have everyone account for similar transactions in the same way. A need for a common understandable language was identified. In this regard, the option of accounting for similar transactions in a different way was identified as a factor that inhibits the understandability of financial statements. The proliferation of different accepted alternatives in accounting standards has decreased over the past years. In fact, standard setters have sought to reduce the number of allowed alternatives in a bid to improve the comparability of financial statements. However, Maltese auditors and shareholders are of the view that different alternatives for accounting for similar transactions are still prevalent, particularly in situations where an asset can be accounted for at cost or at fair value/revalued amount. These different, yet sanctioned, alternatives were identified as another factor that inhibits the understandability of financial statements.
- (vi) *Volatility in earnings* – the increased volatility in reported earnings has been identified as another factor that distorts the message of financial statements. This volatility is mainly a consequential result of the volatility in the valuation of financial instruments and immovable property. The emphasis on the economic measurement of a company's net assets has resulted in a situation where values in the balance sheet need to reflect fair values, which in itself creates a level of volatility in the accounts. Furthermore, another criticism levelled against fair value accounting was that it resulted in unrealised profits which are relied on to support finance. In market downturns, these unrealised profits are reversed and the borrowings may therefore prove to be unsustainable. Furthermore, accounting

for unrealized profits created an expectation by shareholders for such profits to be distributed as dividends. Shareholders were not in a position to understand the difference between realised and unrealised profits, and consequently, the expectation was that all gains ought to be distributed to shareholders as dividends.

Maltese auditors and shareholders agreed that the fluctuations in asset values that contributed to the volatility in numbers may be hard to explain to the reader of financial statements, and may also be blurring the operational performance of the company. They have identified fair value accounting as being the main driver of this volatility. The use of fair value accounting has resulted in balance sheets where the company's equity is skewed towards fair value reserves and revaluations, rather than retained earnings that show the company's profitability from its core operating activities. Whilst there was agreement that fair value accounting was useful, it was described as being an "imperfect" method of accounting that needed re-thinking and more meaningful disclosures in financial statements.

The effect of the above factors is exacerbated by the different financial educational background of auditors and shareholders. An information asymmetry exists between shareholders and the preparers of financial statements. The latter, generally being accountants or at least having an accounting background, are educated in analytical techniques and are also expected to continuously develop their knowledge and expertise to be able to provide an appropriate service. On the other hand, shareholders do not possess the same level of financial education, and although they have indicated their willingness to increase their accounting knowledge, in practice, a considerable amount of shareholder inertia exists. Research findings show that shareholders are mainly interested in profitability and a return on their investment, and consequently, there is a low readability of the accounting information included in financial statements. During the interviews, Maltese auditors have opined that this inertia was also evident from the Annual General Meetings of Maltese companies, characterized by a low turnout of minority shareholders and the lack of pertinent questions being raised during the meeting.

Research findings show that the shareholders prefer to receive accounting information that is clear, simple and straightforward, using simple descriptive language and key numbers. However, on the other hand, the IASB Conceptual Framework states that complex information should not be excluded simply because it may be too difficult for certain users to understand. The preparer of the financial statements, and the auditor who subsequently attests to the truth and fairness of financial statements, therefore are expected to walk on a tightrope. This involves securing an appropriate balance between providing information that is comprehensible to shareholders and the consequential risk of possible user misinterpretation occurring due to over-simplification of matters. In practice, achieving such a delicate balance may not be an easy task.

The issues with the understandability of financial statements underscore the fundamental importance for the preparers of financial statements to be appreciative of the fact that since financial statements are a written form of communication, it is crucial to anticipate and clarify possible points of confusion and misunderstanding. Written media of communication such as financial statements do not allow the reader to seek instant clarification in case of difficulties. The reader cannot readily ask questions to the preparer and the preparer cannot therefore correct readers' misconceptions and errors. By its nature therefore, the use of financial statements as a medium of communication does not facilitate a rapid feedback process, with the result that misunderstandings between the message sender and the message receiver may not be resolved, if at all, in a timely manner.

The research findings of the study have highlighted the need to address those factors that curb the understandability of financial statements. Accordingly, based on the research findings discussed in this section, the next section shall describe those characteristics which are considered to be conducive to the understandability of financial statements in the Maltese environment.

7.3 CHARACTERISTICS THAT ARE CONDUCTIVE TO THE UNDERSTANDABILITY OF FINANCIAL STATEMENTS

The previous section has outlined the characteristics that curb or inhibit the understandability of financial statements in Malta. This section will now focus on those characteristics which have been identified as being conducive to the objective of ensuring that financial statements are understandable to shareholders.

As the volume of information included in financial statements has grown, it has become increasingly difficult for shareholders to understand the message of financial statements and to find the most important information. In line with the findings of related research (for example, DuPree, 1985; Sun, 2007), Maltese shareholders, particularly those having a non-accounting background, prefer to receive accounting information that utilises descriptive language that is clear and understandable. Furthermore, the increased complexities of financial statements and the use of technical jargon makes it even more difficult for shareholders to wade through the volume of information included in financial statements. If one adds on the frequent changes in accounting standards and the possibility of accounting for similar transactions in a different manner, then one can indeed consider that the understandability of financial statements is being severely compromised.

Accordingly, this section identifies those characteristics that are conducive to the understandability of financial statements, and these include the following:

- (i) *Relevance* – Maltese auditors and shareholders have identified the need for an improvement in the content of information reported in financial statements. This improvement is needed with respect to the relevance of information that is included therein. Complex disclosures that are not commensurate with the risks and nature of operations of the reporting entity should be avoided. Instead, the preparers of financial statements should focus on improving disclosure content by including more relevant information for shareholders. This entails disclosing more in certain key areas and reducing the amount of disclosure content in other

areas, or as stated by IASB (2017b, p.4), “including additional information that is useful for investors and, in other cases, removing information that is immaterial”.

The objective should be to include disclosures that communicate, in a clear manner, the information that is most important to the users of the financial statements. This objective can be achieved in various ways. For example, a layered approach to presenting information may be used. This emphasizes the most important information and provides additional details elsewhere, either in the financial statements themselves or as a supplementary document to the financial statements. Respondents to the questionnaire survey, particularly shareholders, agreed with the use of graphs, charts and tables as these can present information in a clearer and more concise manner. In the interviews, shareholders commented that the greater use of charts and graphs would in effect result in the presentation of financial statements becoming akin to that of investor presentations and internal managerial and board reporting. This would enable information to be more accessible and transparent to shareholders.

- (ii) *A stable platform* – repeated changes in accounting standards hindered the understandability of financial statements. As will be discussed in Section 7.4, these frequent changes have also been identified in defining the objective of financial statements, a fundamental building block in the financial reporting process. A period of relative stability can be beneficial for all involved parties. It will benefit the preparers of financial statements by giving them the perfect opportunity to change their systems to capture information required and also provide training to staff to ensure that they remain abreast of developments. Shareholders will also benefit from a period of time where they can better absorb the message being communicated in financial statements.
- (iii) *Ease of measurement* – current measurement practices, particularly in some areas, are complex and diverse. In certain cases, some measurement practices are also apparently inconsistent. Examples that were cited during the interviews to explain the complexity of measurement included accounting for deferred tax, the use of

discounted cash flows and fair value accounting. Furthermore, the use of the term “measurement” in itself can give a misleading impression of certainty and objectivity. Physical objects can be measured in a precise manner, such as in terms of their weight or length. However, the subjects of measurement in financial reporting are clearly different, and the use of complex measurement measures further exacerbates the issues. Maltese auditors and shareholders have made the case for a simpler and more straightforward measurement basis, particularly in the case of the vast majority of Maltese companies where the more complex measurement basis are not commensurate with the risks and nature of operations of the entities, even listed ones.

- (iv) *No surprises in earnings* – Maltese auditors have identified the use of fair value accounting as a contributing factor to the volatility in reported earnings. Whilst it could be argued that such volatility is reflective of the volatility in financial markets and the business environment, the risk is that determining fair values in those cases where there is no active market can result in different estimates of fair value being made. There are different methods of determining fair value; sometimes market values are used, sometimes depreciated replacement cost and at other times, discounted cash flows methods are used. This indicates the subjectivity inherent in the process of determining fair value, with the resulting volatility in fair values being incorporated in the earnings reported by entities. If shareholders do not understand fully the effect of fair value accounting on reported earnings, the risk is that shareholders could over price securities with a risk premium that is higher than justified by the true underlying economic value of the reporting entity.

Whilst agreeing that fair values are informative to shareholders, the level of subjectivity and complexity created by fair values has been identified as a threat to the understandability of financial statements. Maltese auditors and shareholders have therefore, on the basis of the characteristics of the local market, called for a method of accounting that segregates operational earnings from the unrealised gains and losses resulting from changes in fair value.

7.4 BLURRED OBJECTIVES: CAN FINANCIAL STATEMENTS BE EVERYTHING TO EVERYONE?

This study is being undertaken at a time when the accountancy profession is being confronted with a certain degree of criticism following a number of major financial collapses, as well the global economic crisis that started in 2008. The credibility of the profession has been challenged in recent years on various fronts and by different persons and groups outside the profession.

Many of the factors and forces leading to the present situation are outside the scope of the study. Nevertheless, all these factors can be seen to be related to a central and fundamental issue that needs to be considered – the objective of financial statements.

During the interviews, the auditors acknowledged the importance of this subject. Auditors described the specification of the objective of financial statements as being pivotal since it provided the frame of reference for financial reporting. It was also a crucial subject that needed to be addressed since otherwise, there was the risk that accounting standards and financial statements themselves may over time become meaningless. As one auditor commented after the interview was concluded, the subject of the objective of financial statements was important because it “underlies what we [auditors and preparers of financial statements] do, why we do it, and how we do it”.

The findings of this study have shown that auditors and shareholders in Malta identified various objectives that financial statements are meant to fulfill. There is therefore the risk that the objective of financial statements has become an ill-defined or a blurred one, in an attempt to satisfy all the objectives simultaneously with one set of figures. Indeed, the two respondent groups in the questionnaire survey and interviews gave different interpretations as to what the objective of financial statements should be. As will be demonstrated later on in this Section, the responses received suggested that the objective of financial statements was one with diverse meanings and having different facets. This was evident even within the auditor group, where one would have expected more homogenous views given the auditors’ technical background on the subject and their day-

to-day involvement with accounting standards. In their responses, some respondents focused on the uses of financial statements by users, thereby focusing on the attributes that the information needed to have to facilitate the intended use. Other respondents focused on financial statements giving out information about one or more relevant variables, such as profit, cash flow and financial position. The different responses given to what one may have expected to be a “basic” question indicates the extent of the lack of clarity, if not a conceptual confusion, on what the objective of financial statements is. Indeed, as one auditor remarked, “*is it the objective of financial statements or the objectives* [emphasis added] *of financial statements?*” These findings are a reflection, or the result, of the standard-setters failure over the years to define in a definitive manner what the objective of financial statements should constitute. As Higson (2013) remarked, the changing objective of financial statements may have resulted in standard setters building on shifting sands.

One of the objectives that the surveyed auditors and shareholders agreed with was the preparation of financial statements for the purpose of giving a true and fair view of the financial performance and financial position of the reporting entity. Auditors expressed strong views on this, particularly as they could readily relate to the concept of truth and fairness or materiality based on their auditing experience. However, on being probed further during the interviews, it became evident that there were divergent views between the respondent groups on a number of factors. For example, whilst auditors confined truth and fairness to reporting on financial information, shareholders focused on wider aspects such as business operations and the financial health or robustness of the entity. There was also no one universal definition of truth and fairness – during the interviews, auditors focused on materiality considerations while shareholders were more inclined to expect a higher degree of “certification” as opposed to the reasonable assurance presently being afforded by the statutory audit function. Shareholders therefore supported Yamey’s (1962) reference to financial statements being as a check on management’s honesty and integrity. In analysing the responses, one could also note the various user groups that were referred to as being the recipients of information. This wide spectrum of expected users was also evident in the case of the auditors’ responses, with some auditors restricting users solely to the shareholders group and, on the other extreme, other auditors widening

the user group to include society at large. It therefore appears that there is, yet again, a lack of clarity on who constitutes the recipient of the message of financial statements. This situation is a reflection of the changing objective of financial statements. The IASC's 1989 framework referred to a wide range of users, while the IASB's 2010 Conceptual Framework narrowed this to potential investors, lenders and other creditors who refer to financial statements in their decision-making process to decide whether to provide financial resources to the entity. However, the IASB Conceptual Framework still refers to other parties (such as regulators and members of the public), who, although not being the primary users of financial statements, may also find general purpose financial statements useful.

Auditors and shareholders agreed that financial statements were prepared to enable shareholders to assess management's stewardship of the company. In fact, this was one of the few statements in the survey questionnaire where no statistical significant difference was noted in the responses. This is line with the strong tradition found in literature to the effect that stewardship is the purpose of preparing accounting information (e.g. Skinner and Milburn, 2001; Watts and Zimmerman, 1986; Williamson and Lipman, 1991). However, on probing and elaborating further on stewardship during the interviews, an interesting finding was noted. Whilst agreeing on stewardship as an objective, the two respondent groups, however, expressed different views on what stewardship actually meant and how the role of financial statements translated itself into the different facets of stewardship. It became clear, therefore, that there was not a universally accepted definition of what stewardship actually comprised. Thus, for example, the shareholders believed that financial statements showed whether a company was well managed and whether it was a good investment or not. Similarly, according to the shareholders, financial statements showed whether a company has a sound internal control structure and they also portrayed the efficiency with which the company was being run. Furthermore, according to shareholders, financial statements showed management's ability to use company resources in an economic manner.

Whilst agreeing that financial statements are useful in fulfilling the stewardship function, the auditors expressed contrasting views on the extent to which financial statements

provided information on economy, efficiency and effectiveness. In fact, statistically significant differences were noted in the answers given by the surveyed auditors on statements addressing these different facets of stewardship reporting. Furthermore, during the interviews, auditors expressed their views that financial statements may be used *only as part* [emphasis added] of the accountability process of management. The stewardship function is based on the premise of the accountability of the management of a company to its owners, and according to the auditors, financial statements were useful in this regard. However, auditors believed that financial statements were only part of a “jigsaw” that shareholders could use and they certainly did not advocate extending this accountability to society as a whole. Certain auditors were, however, critical of the focus on stewardship as the objective of financial statements, arguing that financial statements could be used only as part of the accountability process. Auditors questioned whether financial statements were actually fit for this purpose and they also questioned whether financial statements were being correctly interpreted, arguing that financial statements did not provide certain information that was needed for a proper assessment of stewardship. Shareholders were likewise critical on the extent to which stewardship could be considered as the true objective of preparing financial statements in practice. Whilst agreeing that financial statements ought to be useful in ensuring proper accountability of management, shareholders believed that in practice, they lacked the necessary information to render the accountability process a meaningful one. Furthermore, based on the responses received, one may also critically question whether shareholders actually cared about the running of the business or whether they were more interested in the return on their investment in the form of the annual dividend payment.

Recent years have seen support for decision-making being considered the objective of financial statements. With the rise of economic decision-making as an objective, emphasis has been placed on identifying the users of financial statements and their needs. In fact, the surveyed auditors and shareholders agreed that financial statements provided information that was useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. However, shareholders perceived financial statements as being more relevant to their needs than auditors did, albeit that the shareholders’ views were not strong ones. In fact, both auditors and

shareholders referred to other important information that was needed for decision-making purposes. Thus, whilst acknowledging the importance of financial statements for decision-making, other factors had a bearing on the ultimate decision. The interviewed respondents referred to external factors in the environment in which companies operated that impinged on the decision-making process of investors and providers of finance. Reference was also made amongst others to factors such as the future economic climate, an organization's competitors and expected technological developments.

Auditors and shareholders have therefore conceded that financial statements do not provide all the information that users need to take economic decisions. This is because financial statements may be out of date, backward-looking and incomplete from an investors' perspective. Financial statements may be comprehensive and complete from an accounting standard point of view, but they may be lacking information that an investor needs for decision-making. Investment decisions are based on what is going to happen in the future, rather than on what happened in the past. Decisions should be based on forward-looking information and after having taken due cognizance of the external factors having an impact on decision-making. There were also qualitative factors that could influence the decision-making process, but these were, again, not captured in financial statements. Furthermore, short-term investors would be interested in making short-term gains on the market and it was therefore arguable how far financial statements were useful to such investors (see Section 7.5).

The ability of financial statements to communicate information was also identified as another objective of financial statements. As already premised in Section 7.2, Maltese auditors and shareholders agreed on the importance of financial statements as a communications link or as a channel of information. There were, however, different interpretations as to *what* was being communicated and to *who* the information was being communicated. These interpretations were also contrasting ones, even with the respondent groups themselves. For example, some respondents focused on an assessment of past performance, while others concentrated on the future direction of the enterprise. Other respondents focused on the calculation of the profitability and the disclosure of the financial position to the users as at end of the reporting period. The effectiveness of the

communication process, irrespective of what and to who the information was being communicated, was however considered to be a dubious one in view of the factors that were discussed in Section 7.2.

Complying with regulatory requirements was another objective identified by the respondents, particularly the auditor group. Given the predominance of owner-managed companies in Malta and given the smallness of such companies, auditors attributed a compliance function to the objective of financial statements. Maltese auditors therefore considered the objective of preparing financial statements as that of satisfying regulatory and tax requirements. In the case of the larger / listed companies, auditors still perceived a compliance dimension to the preparation of financial statements as a lot of attention was being given to ensuring that all disclosures mandated by accounting standards were being adhered with, to the detriment of the understandability of the financial statements.

The research findings of this study have shown that there is a perception amongst Maltese auditors and shareholders that financial statements can be everything for everyone. There is a misguided perception that financial statements can meet the needs of a wide range of users, with one set of figures satisfying the information needs of everyone. As stated by Myddelton (2004, p. 10), “accounts are being asked to perform functions they were not intended to perform, thus lulling investors into a false sense of security”. However, on probing further and in analysing the responses received, it became clear that the lack of clarity by standard-setters in defining the objective of financial statements had also manifested itself in the confused perceptions of the two main groups (auditors and shareholders) that are involved in the financial reporting process in Malta. There are also differences in perceptions and expectations on financial statements between Maltese auditors and shareholders in Malta, suggesting that the present financial statements may indeed be falling short of the shareholders’ expectations.

7.5 AN OVER-EMPHASIS ON DECISION-MAKING?

The recent decades have witnessed an increased emphasis by accounting standard-setters on decision-making as the objective of financial statements (Higson, 2003; Page, 1991).

Indeed, over the years, the objective of financial statements changed from one that was centered around the reporting on stewardship and shareholder rewards to one that centres around the provision of decision-useful information. As a result of the increased importance of decision-making, emphasis has been placed on identifying the users of financial statements and their needs. However, the present study identified a number of problems associated with the over-emphasis being placed on decision-making.

Maltese auditors and shareholders agreed that financial statements are relevant for decision-making purposes. However, the findings show that the decision-making relevance of financial statements was being over-emphasised. Whilst both respondent groups agreed that assisting the investor's decision-making process was one objective of financial statements, shareholders expressed a significantly higher degree of agreement on this than auditors did. The surveyed shareholders were of the view that financial statements were useful on various fronts, such as in assisting them to judge whether the reporting entity was a good investment or not, and in presenting information on profitability which was crucial in their investment decisions. However, it is clear that financial statements were *only one* [emphasis added] of the factors that was considered by shareholders in their investment decision-making. It is also evident that financial statements, after all, were not the most important determinant in the decision making process. Indeed, as stated by Myddelton (2004, p.15), "fundamental analysis of company accounts is not, however, useful to investors in predicting future profits" and that "potential investors should use other sources of information".

During the interviews, both respondent groups agreed that very rarely would an investor make a decision to buy, sell or hold onto his/her investment solely on the basis of financial statements. In the case of a new share issue, investors would be interested to look at historical results, but they will be more interested in projections / forecasts for future periods. This information would normally be included in the offering memorandum accompanying the share issue. Financial statements included very little, if any, information about the organization's future, and they were therefore of limited use in this regard. They also did not include information on the factors within the external environment within which a company operated that will have an impact on future results.

The interviewed Maltese auditors and shareholders provided a number of examples of such factors, namely competition, economic factors such as interest rates and exchange rates, technological factors and demographic changes. Again, financial statements did not include information on these factors, and their decision-usefulness was therefore limited in this regard. The point was also made that in the case of the secondary market for shares, investors did not really provide financial resources to the entity as the provision of finance in terms of share capital would have occurred at the time the shares were first issued. Most of the trading in shares occurs in the secondary market, and therefore the vast majority of investment decisions to buy or sell shares did not in effect result in the provision of financial resources to the entity. In addition, the investment decision of shareholders interested in short term gains was not very often based on a rational analysis of financial statements, but rather on investor sentiment, speculation, market expectations and appropriate consultation with their stock-brokers. In order to stress his point, one shareholder referred to the use of algorithmic trading on foreign liquid stock markets, where computers programmed to follow a defined set of instructions were used to place orders to buy or sell investments. Such algorithms resulted in a large number of orders being processed at very fast speeds across multiple markets, and within this context, the importance of financial statements for decision-making was subdued.

Auditors were also critical of the over-emphasis being placed on financial statements being used by external providers of finance, typically bankers and bond holders. The reasons cited ranged from an inability to understand the technical information included in financial statements to the availability of other sources of information (such as forward looking cash flow forecasts) that were more relevant to the providers of finance who were mainly interested in assessing the liquidity performance of the entity.

This study has therefore identified a number of problems with the emphasis on decision-making and user needs. These can be grouped as follows:

- (i) *Out of date information* – by their very nature, financial statements are issued after the reporting period, and are therefore too late to be of much use for shareholder decision-making. Information that is included in the financial statements would

have been already priced in and available to the market through other channels, such as interim statements or company announcements. Information may also be impounded from newspaper reports or stockbroker bulletins and this therefore limits the relevance of financial statements for decision making. Furthermore, in investment decisions, time is of the essence. Financial statements that are issued a number of months after the end of the reporting period were therefore of limited use as the information contained therein would have become outdated. As stated by Myddelton (2004, p.41), “evidence does not suggest that published annual financial statements are useful for investment decisions. They might, however, confirm what investors had learned from other sources”. In fact, the interviewed shareholders were very much interested in the developments occurring since the financial year end and this information was again lacking in financial statements. The scant information included in the post balance sheet events note was clearly not enough. In addition, investment decisions were often taken on the basis of the available information, generally in anticipation or irrespective of the date of the publication of results.

- (ii) *Backward-looking information* – financial statements contain information relating to past performance. They do not include information on future prospects or future performance, which is so demanded by shareholders for the purpose of their investment decisions. This is in line with literature, such as Myddelton (2004, p.41), who stated that “company accounts report on what has happened in the past whereas people making economic decisions care more about the future”. In fact, when asked to comment on what relevant information should be included in financial statements, the common theme was a forward-looking one that demanded more “up-to-date information” and “information on future plans”. In addition, such information needed to be made available on a timely basis in order for it to be of benefit to the investors.
- (iii) *Incomplete information* – the term “incomplete” is being used here to signify the fact that whilst being comprehensive from an accounting standard point of view, financial statements were lacking on certain fronts, such as ratios and inter-firm

comparisons, information on future plans and qualitative information. Financial statements presently included only certain aspects of the business, namely those that can be quantified in monetary terms and are captured under the present requirements of accounting standards. In particular, shareholders have stressed the need for financial statements to include a comprehensive picture of the business, with key messages being highlighted and readily identifiable, instead of being lost in the clutter of numbers and words.

The accounting numbers released at the end of the reporting period included in financial statements have limited decision-making content for Maltese auditors and shareholders. This means that market participants did not seem to react to the release of financial statements from an investment decision-making point of view. This finding is in line with other studies (e.g. Barker, 2001; Campbell and Slack, 2008; McInnes *et al*, 2007) that have suggested that financial statements are not a key information source for investors and analysts. There are clearly other factors that have a more critical role. This therefore raises the question as to whether the importance of financial statements in the decision-making process was being over-emphasised. It could be argued that standard setters and auditors have a self-interest in over-playing the importance of financial statements.

As a result of the greater focus on decision-making usefulness over the years, higher emphasis was placed on the relevance and reliability of the data in financial statements so as to enable users to take decisions. This led to the downplaying of previously fundamental accounting concepts (such as prudence) and a consequential paradigm shift to fair values and mark-to-market accounting. In itself, this shift has exacerbated issues associated with the understandability of financial statements, as was discussed in Section 7.2. Furthermore, the emphasis on decision-making has resulted in the need to identify the users of financial statements. Maltese auditors and shareholders have identified various user groups of financial statements, and there is therefore no clarity on who the users of financial statements actually are, as well as their respective needs, which at times can also be conflicting ones. This once again is indicative of the existence of the different expectations on financial statements.

7.6 THE IMPRECISION OF THE TERM “STEWARDSHIP”

In the questionnaire survey, Maltese auditors and shareholders agreed that financial statements fulfilled a stewardship function. However, during the interviews, different definitions were attributed to the term “stewardship”. These definitions emphasised different aspects of the stewardship function; however, the use of this term in multiple senses creates the risk that the term itself may become meaningless and result in false conclusions. One common theme in the definitions was the element of “trust” whereby the owners were entrusting their assets to third party management for them to be used in the owners’ best interest. However, different interpretations were given on how reporting on the “trust” relationship should take place.

The main thrust of the auditors’ views was that financial statements provided information on how the entity’s management and government body had discharged its responsibilities. During the interviews, some auditors offered an insight on the historical development of stewardship, and on how the notion of stewardship accounting evolved from the traditional custodial role to the provision of information that facilitated accountability reporting. Auditors believed that there was a stewardship demand for information that was included in financial statements, and that the concept of stewardship was synonymous with the notion of accountability to both internal and external parties having an interest in financial statements. Financial statements were therefore useful for the purpose of revealing and evaluating the past actions of management, and to a limited extent, influencing future actions. However, auditors restricted stewardship reporting to the financial performance and state of affairs of the entity in terms of the present requirements of accounting standards. No mention on the efficiency, effectiveness and economy of the use of resources was made in the financial statements, and auditors were of the view that this position should remain unchanged. Whilst agreeing that financial statements could be used for this purpose, auditors were adamant that they were not in a position to comment on such factors. Auditors also distinguished between family companies and listed companies, arguing that the stewardship role was more relevant in the latter situation. However, as time passed and different family generations became involved in the business, the stewardship role of financial statements became more

relevant, even within family companies. In addition, auditors stressed the fact that financial statements could not be used in isolation for the purpose of assessing stewardship, especially since performance could be impacted (in a positive or negative manner) by external factors that were outside management control.

On the other hand, shareholders attributed a wider definition to the term stewardship and they expressed greater expectations from financial statements in this regard. For shareholders, stewardship is associated with the idea of accountability to both internal and external parties, both in terms of appraising past performance and also possibly in controlling future managerial actions.

Shareholders have expressed their views that financial statements were a tool meant to act as a judge of the company's management. However, shareholders were critical of the fact that the financial statements did not provide them with the necessary information to provide a "true" [emphasis added] measure of management stewardship. It was clear that the interviewed shareholders expected financial statements to be the medium that they could refer to for the purpose of assessing performance; however, given the unavailability of certain information, their use was restrained in this respect. Shareholders have referred to the need for management to move away from apathy and instead engage in a constructive and understandable communication process. Such an approach would mitigate short-termism in investment decision and instead encourage a more long-term approach by shareholders in supporting the investee company over the longer term.

No commonly accepted definition of stewardship exists in the literature (Higson and Tayles, 1998), and the findings of this study show that the concept itself is subject to a variety of alternative interpretations in Malta. This diversity raises a fundamental point – if the two main groups associated with financial statements (auditors and shareholders) give a different interpretation of stewardship, then the extent to which financial statements can act as the true measurement of stewardship is indeed questionable.

7.7 THE LIMITATIONS OF FINANCIAL STATEMENTS – ARE THESE COMMUNICATED WELL ENOUGH?

Various researchers (e.g. Lee and Tweedie, 1977; 1981) have found a lack of understanding by financial statement users on the subject of accounting. This was also found to be the case in Malta. Both auditors and shareholders agreed that the level of financial education or financial literacy in Malta was low. During the interviews, reference was made to the limited amount of quality financial journalism that is available in Malta. The interviewed shareholders expressed their wish to learn and be educated on the subject of accounting to be able to comprehend financial statements. Furthermore, the findings show that shareholders lacked comprehension of a fundamental aspect of financial reporting – the scope and limitations of financial statements. The risk is therefore that shareholders may, at best, be trying to perform financial statement analysis without understanding its limitations, as well as without being aware of the process that is adopted in the preparation of a set of financial statements.

The lack of understanding on the limitations of financial reporting was evident from the shareholders' views on the truth and fairness of financial statements. Truth and fairness can be described as being the hallmark affixed by the auditor to the financial statements following the statutory audit process. There is, however, some serious doubt as to whether there is a consensus between auditors and shareholders on the meaning of this important term within the attestation function of the audit. As shareholders are not involved in the preparation of financial statements, they perceived financial statements to be precise. The fact that numbers are used to compute the figures reported in financial statements led shareholders to believe that financial statements ought to be accurate enough. This is in line with Liggio's (1974, p.28) statement that "in our early days of education, we are taught that two plus two equals four". Whilst acknowledging that this preciseness could not be an absolute one, the level of the shareholders' expected preciseness associated with financial statements was however far higher than that which could be reasonably attributed to financial statements. Shareholders referred to terms such as "true picture" as opposed to "fair picture". The use of other terms during the interviews such as "no misstatements", "accurate picture", "unbiased position", "no

frauds” or “correct summary” evidenced the shareholders’ expectations on this subject. These findings are in line with research on the subject of fraud where auditors are perceived by the business community and the general public as being responsible for the detection and reporting of fraud (e.g. Porter, 1997; Humphrey *et al*, 1993; Epstein and Geiger, 1994). It was only the shareholders having an accounting background that were more appreciative of the limitations of financial statements (in line with the findings of Ruhnke and Schmidt, 2014), but these by far are not representative of the shareholder population. In fact, the vast majority of the Maltese surveyed shareholders confirmed that they did not possess formal training in accounting.

Auditors agreed on the need for shareholders to be appreciative of the assumptions and limitations inherent in the preparation of financial statements. In this way, shareholders would better understand the inability of financial statements to be completely neutral. There were various situations where management needed to decide on judgements and estimates that are used in the preparation of financial statements, particularly with the increased use of fair value accounting. In addition, there was pressure for management to live up to shareholder expectations and this may be the dominating factor as opposed to reporting a totally neutral position. Elements of bias were an in-built part of the financial statements process, and auditors believed that this needed to be understood by shareholders. Shareholders also referred to the possibility of management having a motivation to massage the figures included in the financial statements. In fact, certain misgivings were expressed on the figures reported in financial statements by management; but then, shareholders, believed that the auditors’ responsibility was to make good for this, and therefore ensure that the financial statements were free from bias. These findings support the literature (e.g. Koh and Woo, 2001; Wallace, 1980; Kent and Sherer, 1983; Tabone and Baldacchino, 2003; Watts and Zimmerman, 1983) on the agency theory where agents are motivated to serve their own-self interests which may conflict with the principals’ interests, with principals thereby being amenable to incur monitoring costs to independently scrutinise the financial transactions entered into by the agents.

The expectations of shareholders are indicative of the fact that the limitations of financial statements are not being understood by Maltese shareholders. Unless there is an explicit recognition and understanding of the scope and limitations of financial statements, there is the risk that the gap in expectations between shareholders and auditors will continue to exist. It is also clear that these limitations were not being communicated well enough to shareholders. At the same time, auditors expected shareholders to be knowledgeable about these limitations and therefore to understand that financial statements are susceptible to judgments, human interpretation, error, and in some cases, even the intentional manipulation of figures by management. Shareholders, on the other hand, lacked the necessary accounting education to understand these limitations. This position was in line with literature, such as Boyd *et al* (2001) which advocated increased educational efforts on this front.

7.8 THE SMALL ISLAND PERSPECTIVE

Malta is a small island state. It is an island in the middle of the Mediterranean Sea with a small, yet thriving, economy. Being a small island state, the country is faced with a number of challenges, primarily due to the narrow range of human and non-human economic resources and markets. In addition, transportation costs and the limited domestic market pose further challenges to the economy. Malta's membership to the EU helped the country to open up its economy to the world market. Despite having an open growing economy over the past few decades, there are still a number of characteristics within the Maltese environment that are endemic of a small state, particularly with respect to financial reporting.

The Maltese business community is a small one, where the key players very often know each on a personal basis. This also applies to the audit and accountancy profession, where due to the close proximity within the island, it is often the case that audit practitioners would know each other, either as fellow students at university, work colleagues or family relations. Inevitably, this creates independence issues from an audit point of view, making it therefore incumbent on the auditors to ensure that appropriate safeguards, where possible, are in place to ensure independence of mind and also in appearance.

Research findings have identified confidentiality aspects as playing an important role in shaping the information that is included in financial statements. The perception of Maltese auditors and shareholders is that the preparers of financial statements are hesitant to voluntarily report information over and above that which is mandatorily requested by accounting standards and regulations. Companies prefer to play safe and only disseminate the information that is required. Even in the case of mandatory information requirements, the perception of the interviewed shareholders in Malta is that companies will try to limit the information to the very bare minimum, even at the risk of including vague information or statements with limited informational value. Shareholders believed that there existed apathy in communicating information. Such a position has been perceived to apply to listed companies, where shareholders are not involved in the day-to-day running of the business. However, the interviewed auditors opined that the situation is even more acute in the case of private companies where the perception is that the less the market knows about the company, the better. There is therefore no appetite to communicate information on matters such as management's analysis of the business and forward-looking information, that are so demanded by shareholders.

The reasons that have been cited to justify this approach are mainly related to retaining competitive advantage and confidentiality aspects. However, as some auditors remarked, this mentality was a reflection of the intrinsic philosophy of a Southern Mediterranean country, which, despite having made significant inroads over the past few years, still lacks the pro-activeness to voluntarily disclose meaningful information to market participants. Indeed, Maltese organizations can be considered to be inherently secretive whenever possible, having a preference to disclose only where there is a mandatory requirement to do so. Discretionary disclosures by management can provide an important means for an entity to reduce the information asymmetry between management and shareholders. However, the views of Maltese auditors and shareholders suggested that this does not apply to the Maltese context, both for listed companies, and even more so for private companies where ownership and management are typically vested in the same person or group of persons.

Another aspect related to smallness of Malta is what some auditors and shareholders referred to as “political” factors. The term “politics” has been used in a very wide sense by the respondent groups. Reference was made to the governance of certain companies that are locally listed where the Maltese government has an interest and was therefore in a position to exercise a dominant or significant influence. In such circumstances, and also given internal politics that one usually finds in corporate organisations, management may be motivated to report that the expected results or targets have been achieved. The risk of such practices was also compounded by the close proximity, social networks and the close-knit nature of relationships that existed in Malta, where the management, owners and auditors are close to each other.

The limited amount of accounting knowledge that Maltese shareholders possess has been identified as another small island characteristic that inevitably affected financial reporting in Malta. Whilst this characteristic has also been identified as being prevalent in other countries (e.g. Sikka *et al*, 1998; Lee and Tweedie, 1977), Maltese auditors and shareholders contended that the position was more acute in Malta, given the smallness of our country, the limited availability of quality financial journalism and the ownership-management structure of most local companies. This characteristic has been identified as being a barrier to the communication process as one cannot communicate with maximum effectiveness in a situation where the recipient is not in a position to understand the message. This situation is exacerbated by the complex measurement and disclosures that were included in financial statements which were not commensurate with the risks and nature of operations of Maltese companies. Research studies have focused on the effectiveness of education as a means of reducing the audit expectations gap (e.g. Mednick, 1986; Gramling *et al*, 1996; Pierce and Kilcommins, 1996; Briloff, 1967a; Ali *et al*, 2008). Such studies have focused on the audit function, in particular the audit report. However, it is clear that within the local context, it is important first of all to focus any educational initiatives on the financial statements themselves. This was evident from the responses to the questionnaires where shareholders have intimated their willingness to learn more on the subject. The interviews have confirmed this and have indicated that even the basics need to be addressed, particularly with respect to the scope and limitations of financial statements. Unless these are properly understood by the readers of financial

statements, there will remain the risk that the expectations gap on financial statements in Malta will continue to exist.

7.9 THE CONTRIBUTION OF THE STUDY

This section discusses the contribution that this research study has made to both knowledge and practice.

Whilst previous research has focused almost exclusively on the audit expectations gaps, this study has researched the existence of a *financial statements* expectations gap in Malta. Previous researchers (e.g. Porter, 1993; Hatherley *et al*, 1992; Jennings *et al*, 1993; Humphrey, 1997; Sikka *et al*, 1998; Guy and Sullivan, 1988) have focused on the audit function within the financial reporting process. As a result, the two main areas that were extensively researched included the factors contributing to the audit expectations gap and possible solutions aimed at narrowing this gap. Despite the various efforts and initiatives implemented over the years, the audit expectation gap still seems to exist. Such initiatives include, for example, the long form audit report - literature (e.g. Coram *et al*, 2011, Baskerville *et al*, 2010; Gold *et al*, 2012) shows that users only briefly analysed the audit report and that they had difficulty in understanding certain key concepts such as materiality and assurance (e.g. Gray *et al*, 2011). Empirical evidence therefore calls into question the effectiveness of such initiatives.

This study has focused its attention away from the audit function and into the financial statements themselves. The focus of this study is therefore different and distinct from previous literature on the audit expectations gap. Although the term “expectations gap” is a common element between this study and previous literature, this study has focused on the financial statements side of the gap. It has therefore provided empirical evidence of the existence of a wider expectations gap than has heretofore been researched. This study has taken the existing literature on the expectations gap a step forward by exploring the existence of a wider gap and providing empirical findings to support this. It also added to the current body of knowledge because it focused on a much neglected topic in financial reporting – the financial statements. Whilst auditing has an importance function

in corporate governance and in society at large, it is the financial statements that are considered to be the public face of an organisation. The audit function serves to attest to the truth and fairness of financial statements, but it is financial statements that convey information on the reporting entity to the readers. Indeed, the audit function cannot subsist without the financial statements.

Despite having an important communicative function, the message of financial statements is often misunderstood, probably because of its lack of clarity. This study has in fact provided empirical evidence on the factors that are curbing the understandability of financial statements. It has identified the existence of a communications breakdown in various aspects. There is a lack of consensus, even within the two respondent groups themselves, on the objective of financial statements, which is expected to be at the very foundation of the financial reporting process. Such a failure to achieve a consensus even at this fundamental level could result in future problems when accounting standards are developed on the basis of an unclear objective. Furthermore, there was clear agreement, with shareholders expressing stronger views, on the lack of the understandability of financial statements and the factors that were contributing to this. The financial statements expectations gap is therefore one that has been recognized and accepted by the two respondent groups.

The existence of this gap is further evidenced by the fact that shareholders considered the present financial statements as not being responsive to their needs. This study has therefore contributed to the literature and professional practice by providing empirical findings that contribute to the generally under-researched field of communication in accounting, whilst highlighting the need for financial reporting to adapt to satisfy the communication needs of its users.

In addition, this study has, for the first time, tested the existence of a financial statements expectations gap. This has been done in a small state economy such as Malta. Malta is a small island state, and therefore certain factors further exacerbate or widen the financial statements expectations gap. The lack of financial education, the low level of financial journalism, and the smallness factor have been identified as some of the key

characteristics inevitably influencing accountancy practices. This study has therefore identified the need for policy makers to address the legitimate expectations of shareholders. The success of the financial reporting process cannot only be measured by the extent of detail being included therein. The assumption that the more information, the better, needs to be challenged. Financial reporting should communicate better, not necessarily more, particularly in a small island state such as Malta where the risks and nature of operations of the vast majority of companies, including listed ones, do not warrant such complexities.

The study has also indicated the importance of bridging the financial statements expectations gap. The disparity in the views of audit practitioners and shareholders was the main subject under study, and the research findings have indeed provided empirical evidence of this gap. The need for effective communication has intensified as a result of the volumes of information being communicated and the increased number of parties presumably intended to make use of financial statements. There is therefore the need to narrow the areas of difference by setting out and communicating in a clear manner the objective, scope and limitations of financial statements.

The benefit of this research into these issues would be considerable if it helped standard-setters to overcome the practical problems presently faced in incorporating users' views into their standard setting process. Indeed, this study has provided empirical evidence about those characteristics that are conducive to the understandability of financial statements and that can therefore potentially assist policy makers such as the IASB in making the much needed "facelift of what is often called the 'face of financial statements'" (IASB, 2016b, p.4).

7.10 CONCLUSION

This Chapter has presented a discussion of the main findings of the study, combining the results of the questionnaires and interviews. It has also explained how the current study contributed to both knowledge and practice.

The empirical results of this study indicate the existence of a financial statements expectations gap between the perceptions of auditors and shareholders in Malta. Although auditors and shareholders generally do not hold diametrically conflicting views on the subject, it is clear that there is a lack of consensus on certain key areas, such as the objective of financial statements. The danger of standard setters seeking to satisfy all users' expectations, and the various compromises that have been reached over the years in the standard setting process, have resulted in a situation where a set of financial statements is expected to mean everything to all people. This has resulted in a situation where financial statements may not be fit for purpose, given the wide range of users that have been identified and their legitimate different expectations.

The findings have shown that Maltese auditors and shareholders share different views on who the users of financial reporting information are and, what use, if any, they make of it. The users may well vary from entity to entity, and from one jurisdiction to another. Indeed, it cannot be taken for granted that all users are of the same type and have the same informational needs, and therefore a one-size-fits-all approach will not work. The present situation has indeed resulted in a conceptual confusion on the objective of financial statements, emanating from the over-emphasis on decision-usefulness, the prediction of future cash flows and the imprecision of the word "stewardship".

Furthermore, communications theory has helped to explain the existence of the expectations gap relating to the financial statements. Whilst communication theory may not be relevant in the development of accounting standards, it is of fundamental importance in understanding how crucial the specification of the objective of financial statements is. Unless there is a clear identification of the message that the financial statements are trying to communicate, there is the risk that the financial reporting may simply become a routine compliance process in the financial calendar of an entity. Furthermore, educating the users about the scope and limitations of the financial statements is another important aspect that needs to be given due importance by standard setters to avoid financial statements becoming a modern myth in the financial reporting process.

CHAPTER EIGHT – CONCLUSION

8.1 INTRODUCTION

The purpose of this Chapter is to summarise the results presented in the thesis. It provides an overview of the research findings and it draws overall conclusions. The rest of the Chapter is organised as follows: Section 8.2 provides a general summary of the research project, and it provides a synthesis of the findings in order to identify persuasive conclusions. Section 8.3 subsequently discusses the main limitations of the thesis. This is followed by Section 8.4 which outlines the recommendations emanating from the study. Section 8.5 then suggests some areas in which research could usefully develop further the work that was done in this study. Finally, Section 8.6 concludes the thesis.

8.2 SUMMARY OF THE RESEARCH PROJECT

The previous chapters of this thesis were laid out as follows: Chapter One introduced the research problem and it outlined the overall structure of the thesis. Chapter Two provided a literature review on the subject, focusing on the way previous literature has focused almost exclusively on the audit expectations gap to the detriment of another factor causing a gap in financial reporting – the financial statements expectation gap. This Chapter provided relevant background to the research problem and it also identified the theoretical framework underpinning the research project. The review of previous studies provided the essential foundation for the developing the study's methodological approach. Chapter Three focused on the research setting – Malta. It provided background information on the island and it described the applicable accounting and auditing framework. Chapter Four then provided an explanation of the research approach, including the research paradigm (pragmatism) adopted for the purpose of this study. It also provided the rationale for adopting a sequential mixed methods approach and it described the advantages and disadvantages of the research instruments (questionnaire survey and interviews) that were used to collect data. Subsequently, Chapter Five focused on the collection and analysis of the quantitative data and it presented the research findings emanating from the quantitative part of the study. Chapter Six adopted a similar structure

to Chapter Five, but it focused on the qualitative stage of the study. Chapter Seven discussed the main findings of the study in the light of the previous literature that was reviewed, and it also presented the way in which this study has contributed to both knowledge and practice in the subject of accounting.

This Section sums up the principal themes and findings of the study. As already stated, this study has not focused on the audit expectations gap. It has instead directed its efforts at studying a wider expectations gap that has so far been researched, which is referred to as the financial statements expectations gap. A key objective of the accounting process has traditionally been that of reporting, or communicating, financial results to groups in society that have an interest in such information. Communication is therefore at the heart of the process. The increased separation between ownership and control of limited liability companies, as well as the expansion in size of companies, have intensified the call for effective communication. Despite this call, empirical evidence suggests that a significant gap exists.

The financial statements expectations gap has been seen to exist in various areas, some of which are considered to be the very basics or the foundations of the subject of accountancy. This study has, first and foremost, demonstrated the existence of differing views on the objective of financial statements. The failure to have a common understanding, particularly at this fundamental level of the subject, highlights the seriousness of the financial statements expectations gap. It is presumed that the objective of financial statements would have been cast in stone and codified, with all interested parties having a clear understanding of this fundamental building block in the subject of financial reporting. Empirical findings from this study, however, provide evidence of a different reality in the real world. The seriousness of this finding is compounded by the fact that the lack of clarity in defining the objective of financial statements was shown to exist not only between the two respondent groups (auditors and shareholders), but also within the component groups themselves. Different respondents have identified different objectives of preparing financial statements, implying that financial statements could possibly simultaneously achieve these various objectives at the same time. At the same,

the research findings show that the present financial statements may indeed be falling short of shareholders' expectations.

The findings of the study show that there is confusion in the perceptions of auditors and shareholders on the objective of financial statements. This could be the result of the lack of clarity by standard setters in clearly setting out what the objective is, as opposed to trying to compromise and satisfy various user needs with the same set of financial statements. There is the risk that the objective of financial statements may be considered as an outmoded or no longer important subject to address, particularly in the light of the increased focus by standard setters on decision making and the provision of future oriented information. However, it is clear that unless this fundamental subject is addressed, there is the risk that financial statements may mean everything to everyone, with a major gap prevailing in expectations.

The existence of the financial statements expectations gap is also evidenced by the responses given by respondents on other subjects, such as stewardship, the limitations of financial statements and the understandability of financial statements. Both respondent groups talked about stewardship as being one objective of financial statements; however, it was clear that there was a gap in comprehension on what stewardship actually entailed and the extent to which this was reflected and communicated in financial statements. Similarly, there was a lack of understanding on the limitations of financial statements as these were not communicated well enough. The seriousness of this matter was manifested by the fact that shareholders should presumably be using financial statements for decision making purposes; without a proper recognition of the limitations of the financial statements and without an appreciation of the process that is involved in preparing financial statements, there is the risk that decisions may end being taken with a certain degree of ignorance on these important considerations.

The importance of the empirical findings of the study are also evidenced by the prevalence of the view among shareholders, who are considered to be the primary users of financial statements, that financial statements are inadequately responsive to their needs. While there is a general understanding on what financial statements represent, the

findings of this study have shown that there are a number of characteristics that are increasingly limiting the understandability and relevance of financial statements to shareholders. These factors are mainly related amongst others to the increased complexity of financial statements, the use of technical jargon, information overload and the frequent changes in accounting standards. The impact of these factors is compounded by the fact that the risks and nature of operations of the Maltese business environment, including the capital market, is not considered to warrant such complexities. The problems are further exacerbated by the low level of financial education prevalent in Malta amongst shareholders, with their main concern being receiving a dividend return on their investment.

Indeed, on the basis of the research findings, unless measures are implemented in order to deal with the existence of the financial statements expectations gap, there is the risk that this gap may grow into a chasm leading to a loss of confidence and credibility in the profession. The findings of the study pointed to the magnitude and complexity of the financial statements expectations gap. Very significant differences, all at statistically significant levels, were identified from the survey questionnaire. These differences were further investigated in the interviews, which provided further evidence of the existence of such gap. There is therefore the need to bridge the gap to ensure that there is a consensual view on the objective, scope and limitations of the financial statements. This study accordingly provides recommendations on how this can be achieved in Section 8.4.

It is therefore considered important that any future developments in corporate reporting assist financial reporting to ensure that information provided to shareholders is reliable, understandable and comparable. Financial statements have been a cornerstone of corporate reporting for many decades. Over the years, there have been dramatic changes in global economies, technology and investor expectations. Some of these developments have revolutionised the way information is communicated. Notwithstanding these forward looking developments, it is clear that the accounting profession needs to take a step back to basics. Empirical evidence has shown that certain fundamental considerations of financial statements still remain unclear and obfuscated. The profession therefore needs to determine, and then make generally known, what financial statements

are striving to achieve, and this must be communicated clearly, in a way that can be understood by users.

8.3 LIMITATIONS OF THE STUDY

Although every effort has been made to conduct a comprehensive study on the subject matter, it remains that the study is subject to a number of limitations.

Firstly, all the participants in the study were Maltese. The findings of the study are therefore limited to Malta because it reflects the views of participants living in Malta. It is inevitable that such views are influenced by the culture, regulations and systems within the country, particularly in a small state such as Malta where certain other behavioural characteristics may even further influence the findings. Care should therefore be taken in generalizing the results, particularly as the stock market and business environment in Malta may exhibit different characteristics to foreign markets in terms of size, number of listed firms and market capitalization. Thus, whilst the findings of the study were sufficiently strong to be able to derive persuasive conclusions on the financial statements expectations gap in Malta, the conclusions of the study cannot be generalized to other jurisdictions without keeping in view the differences in the Maltese environment that could influence the inferences of the research. Nonetheless, the researcher considers that the research findings can be of value to similar settings and they provide a solid foundation for further conceptual and practical development in the profession.

Secondly, this study only covers the view of auditors and shareholders who are the main parties that are involved in the financial reporting process in Malta. The researcher believes that there is scope for undertaking more in-depth research with other users of financial statements so that they will have the opportunity to raise different concerns. In particular, the researcher considers that more in-depth interviews with the providers of finance (for example, bankers and bond holders) would provide further evidence in support of the existence of the financial statements expectations gap.

Thirdly, the study is subject to the limitations that are inherently associated with the research methods that were adopted for the purpose of this study, as well as with use of sampling techniques. The study has involved direct contact with participants and the findings were gathered through a survey questionnaire and face-to-face interviews. These methods of data collection are by their very nature subject to limitations. For example, in the interview process, there remains the possible existence of various forms of bias, subjectivity and interpretation that are inherent in qualitative research (such as personal bias and self-serving responses by interviewees). Interviewees may, for example, give answers they wish to be reported and these answers may not necessarily reflect their genuine opinions on the subject matter. Furthermore, status differences between the shareholders and the interviewer may also have affected the responses given. The interviewer is an auditor, whilst interviewed shareholders generally lacked technical accounting knowledge. The interviewer communicated his experience on the subject and his regular contact with shareholders during his previous auditing work experience. The objective was to foster a rapport of trust and mutual understanding with the interviewees. Although careful attention was given to ensuring that a proper and rigorous approach was adopted to the collection and analysis of data, such limitations are still deemed to exist.

Fourthly, this study has focused on general purpose financial statements. Thus, special purpose financial statements and other forms of reporting were not included in the study. Furthermore, the study has limited its research to the views of external auditors within the auditing profession. In other words, it has focused on auditors that are in public practice. Thus, for example, auditors in the public sector and auditors who may no longer be in public practice (such as an auditor who may be employed as a financial controller) have not been included in the study. After reviewing the existing literature and also due to time constraints, it was decided that it was more appropriate to direct all efforts exclusively towards practicing external auditors.

Fifthly, this study has focused on accounting communication with external audiences, namely shareholders. Accounting information used within an entity for decision making or control purposes, such as in the form of management accounts, has not been delved

into. Thus, for example, the effectiveness of the communication of financial information between accounting staff, management and boards of directors has not been investigated.

Finally, the communication foundation of this study does not include external communication via social media. This latter form of communication (for example, Facebook and LinkedIn) enables organizations to enter into dialogue with their audiences, which may include investors. This study has, however, limited its focus to general purpose financial statements that are prepared by the reporting entities and communicated to shareholders using the traditional channels of communication.

8.4 RECOMMENDATIONS

Based on the research findings of this study, the following recommendations are made:

- (i) *Bridging the gap* – there is clearly an urgent need to bridge the expectations gap in financial reporting. As has been demonstrated in this study, the profession's efforts cannot be exclusively reserved for the audit function, but they should also extend to addressing the financial statements themselves. The areas of difference and divergence in subjects such as the objective, scope and limitations of financial statements need to be addressed. The inclusion of information in financial statements that is complex and not commensurate with the risks and nature of operations of the reporting entity should be avoided.
- (ii) *Clarity about the objective of financial statements* – the failure by the accountancy profession and standard setters to be clear and realistic on the objective of financial statements has resulted in a financial statements expectations gap. Rather than focusing on a multitude of potential users, there is therefore the need to specify what the objective of financial statements should be, with the aim of achieving better corporate communication through a clearer message of the financial statements.

- (iii) *Trying to please all people at the same time is destined to please none* – the profession and standard setters have over the years tried to accommodate the different informational needs of different parties with one set of financial statements, termed “general purpose financial statements”. These needs have included decision-making regarding resource allocation, predicting future cash flows, assessing past performance of the reporting entity and judging the stewardship of management. Financial statements have therefore been considered of a “general purpose”, capable of satisfying user requirements with one set of figures. This has not been the case. To the contrary, the present situation is one where financial statements mean all things to all people. This is clearly not beneficial to the profession, and therefore a different approach is called for.
- (iv) *Back to the basics* – over the past few decades, accounting standards have sought to keep abreast of developments in the financial world. Standards have therefore sought to address subjects such as revenue recognition, business combinations and fair value accounting. This study has shown the need for the profession to focus, first and foremost, on certain basic considerations of the subject that to-date still remain unclear and obfuscated. The profession needs to determine, and then make generally known, what the objective of financial statements is. It needs to make it clear, for its own sake and also of society in general, what financial statements are striving to achieve. The scope and limitations of financial statements also need to be communicated clearly, in a way that can be understood by users.
- (v) *The accountant as a communicator* – this study has highlighted the importance of communications in the financial reporting process. This study therefore recommends a paradigm shift in the accountant’s role. This recommended shift emanates from the recognition of the importance of communicating in an effective manner. Indeed, accountants are to position themselves as the communicators of financial information and they must therefore ensure that financial information is communicated in a language that is understood by all and sundry. Unless the importance of communication is duly acknowledged by the profession, there is indeed the risk that financial statements may become irrelevant.

- (vi) *The role of education* – education may also play a role in addressing the financial statements expectations gap that was found in this study, provided that the profession itself is first clear about the objective of financial statements. Being clear about what financial statements are meant to achieve is a pre-requisite for any educational programmes to be effective. It is recommended that specific educational programmes be delivered to enhance the knowledge of shareholders on financial statements. This will empower shareholders to understand financial statements, their scope and limitations, and therefore take informed investment decisions. The effectiveness of these educational efforts will be exponential if financial statements are prepared in a way that is commensurate with the nature and risks of the reporting entities, using understandable terminology and highlighting key messages, possibly using graphical illustrations where appropriate.

8.5 AREAS FOR FURTHER RESEARCH

It is hoped that this study encourages research on the subject matter and on other related areas. In the light of the findings of this study, the researcher believes that there is scope for further research as a follow up to this research study. Accordingly, the following paragraphs highlight some areas for further research.

This study has focused on the perceptions of two main groups, auditors and shareholders. Additional research could therefore be carried out in order to study the perceptions of other parties that have an interest in the financial reporting process. These would include, for example, the providers of finance (such as bankers and bondholders), institutional investors, stockbrokers and financial analysts, tax authorities and standard-setters. The extension of this study to other interested users of financial statements will provide a more comprehensive picture on the subject. Furthermore, this study has focused exclusively on external auditing. It may be interesting to investigate whether a similar gap applies to internal auditing.

The study has been conducted in a small island economy, Malta. Future research may seek to investigate whether a similar expectations gap exists in other small countries, as well as in other larger economies. An international comparison on the subject would provide useful insights on whether larger countries have similar views to the smaller counter-parts on the financial statements expectations gap.

Future research could also examine the financial statements expectations gap in the public sector. Public sector entities are required to prepare financial statements, and therefore an interesting area for further research would be to study whether an expectations gap is also prevalent in public sector financial statements.

This study has highlighted the importance of the communications process in financial reporting. A possible area for future research could take the form of a study investigating the communication patterns between accountants and owner-managers in Malta. Given that Malta's business community includes a significant proportion of companies that are owned and controlled by the same person or group of persons (generally family relations), it would be interesting to investigate the communication approaches and preferences in the accountant – owner/manager relationship.

8.6 CONCLUDING NOTE

This study has presented empirical findings supporting the existence of a financial statements expectations gap in Malta. The results have revealed that whilst literature has focused almost exclusively on the audit expectations gap, there is indeed a wider expectations gap in relation to the financial statements themselves. It has also shown that auditors and shareholders in Malta have different expectations in relation to certain key fundamentals of financial reporting, such as the objective of financial statements, their scope and limitations. It has highlighted the need to bridge this gap in order to have a consensual view on these key considerations. The findings have shown that achieving this goal requires due attention to be given to the communications dimension.

This study has in some ways directed criticism at the accountancy profession. It has provided empirical evidence showing a lack of a common understanding even at fundamental levels of the subject. It has shown that there is a different picture in the real world out there to what standard setters and the financial community may think. In this sense, the findings of the study may be considered as a criticism at the profession for its failure to appropriately fulfill its responsibility in assuring a common understanding of the fundamentals of the subject and the preparation of understandable financial statements.

However, the researcher would like to point out any criticisms that have been levelled at the profession are motivated by the researcher's love for the accountancy profession - a profession which, in the researcher's opinion, is still capable of bridging the financial reporting gap and therefore fulfill its responsibility of providing relevant, understandable, high quality financial statements.

APPENDIX 1 – QUESTIONNAIRE – AUDITORS AND SHAREHOLDERS

INTRODUCTORY LETTER

Address

Date

Dear Participant,

I am currently a doctoral student at the School of Business and Economics at Loughborough University conducting research on financial reporting in Malta. The aim of this study is to investigate the views of auditors and shareholders in Malta on the objective of financial statements and the message being conveyed through audited general purpose financial statements. The outcome of this project should be of special interest to auditors, academics, policymakers and industry stakeholders seeking to maintain or enhance Malta's position in the financial reporting environment.

As an important stakeholder, your knowledge and valuable insights can assist me in achieving the study's objectives. I would greatly appreciate if could spend some time in answering the attached questionnaire. Completing the questionnaire should not take more than 20 – 25 minutes. The questionnaire is divided into a number of sections which should facilitate its completion. You are kindly asked to answer all questions. Upon completing the questionnaire, you are kindly requested to return it in the annexed stamped self-addressed envelope.

The information acquired will be solely used for research purposes. The final results will be reported in the doctoral thesis and may be published in journals or presented at conferences. You are, however, assured of anonymity, and strict confidentiality. Your feedback will be analysed together with the rest of the questionnaires and there will be no reference or indication, either directly or indirectly, to you or your firm.

If you have further queries, you can contact me on norbert.tabone@um.edu.mt or you may contact Dr Andrew Higson (a.w.higson@lboro.ac.uk) who is my Loughborough supervisor.

Thank you once again for your time and cooperation.

Yours sincerely,

Norbert Tabone

QUESTIONNAIRE - AUDITORS

The following set of statements relate to the objectives and understandability of audited financial statements. Please encircle the number that reflects your view about each statement.

SECTION 1: THE MESSAGE OF FINANCIAL STATEMENTS

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
1.	The objective of financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.	1	2	3	4	5
2.	Financial statements are useful to enable shareholders to monitor the past performance of a company.	1	2	3	4	5
3.	Financial statements enable shareholders to predict future performance and future cash flows of a company.	1	2	3	4	5
4.	The objective of financial statements is to assist investors in making economic decisions - whether to buy, hold or sell their investment.	1	2	3	4	5
5.	The objective of financial statements is to present a true and fair view of a company's financial performance and financial position for a reporting period.	1	2	3	4	5
6.	Financial statements show whether a company is well managed.	1	2	3	4	5
7.	Financial statements show the efficiency with which a company is being run.	1	2	3	4	5
8.	Financial statements portray management's ability to economically use the resources entrusted to it.	1	2	3	4	5

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
9.	The objective of financial statements is to present a picture of the company's short-term performance.	1	2	3	4	5
10.	Financial statements provide information that enables investors to measure a company's long-term performance.	1	2	3	4	5
11.	The objective of preparing financial statements is to compute and present the profit earned by a company during a reporting period.	1	2	3	4	5
12.	The audit of financial statements by an independent auditor ensures that financial statements are free of material errors, frauds or irregularities.	1	2	3	4	5
13.	The change in focus from the income statement (emphasising income and expenditure) to the balance sheet (emphasising the assets and liability approach) provides more relevant information to investors.	1	2	3	4	5
14.	The use of fair values and mark-to-market accounting provides more relevant information than historical cost accounts.	1	2	3	4	5
15.	Financial statements provide assurance to shareholders that a company has complied with the applicable rules and regulations.	1	2	3	4	5
16.	The objective of financial statements is to ensure the accuracy and legitimacy of accounting records.	1	2	3	4	5
17.	Financial statements enable shareholders to assess management's stewardship of the company's assets.	1	2	3	4	5
18.	Financial statements show whether a company is a good investment or not.	1	2	3	4	5
19.	Financial statements show whether a company is a going concern.	1	2	3	4	5
20.	Financial statements show whether a company has a sound internal control structure.	1	2	3	4	5

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
21.	The inclusion of an audit report enhances the credibility of a company's financial statements.	1	2	3	4	5
22.	The inclusion of other reports (e.g. chairman's statement) provides useful information to the shareholders.	1	2	3	4	5
23.	Financial statements present an accurate and complete picture of a company's financial performance and financial position.	1	2	3	4	5
24.	An exercise of judgement is required in the preparation of financial statements.	1	2	3	4	5
25.	Financial statements can achieve various objectives with the same set of figures.	1	2	3	4	5
26.	An unqualified audit report implies that the financial statements are free from fraud.	1	2	3	4	5
27.	The primary use of financial statements is for tax purposes.	1	2	3	4	5
28.	The primary use of financial statements is for use by bankers and providers of finance.	1	2	3	4	5

SECTION 2: THE UNDERSTANDABILITY OF FINANCIAL STATEMENTS

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
29.	Audited financial statements are the most important communications link between a company and its shareholders.	1	2	3	4	5
30.	The company's financial statements are read by shareholders.	1	2	3	4	5
31.	The company's financial statements are understood by shareholders.	1	2	3	4	5

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
32.	The present format and content of financial statements is adequate to meet investors' requirements.	1	2	3	4	5
33.	Financial statements are too complex to be understood.	1	2	3	4	5
34.	The message of financial statements is 'lost' in the clutter of lengthy disclosures and regulatory terminology.	1	2	3	4	5
35.	The use of graphs in financial statements would make financial statements more understandable.	1	2	3	4	5
36.	Educating investors would help investors better understand the scope and limitations of financial statements.	1	2	3	4	5
37.	The inclusion of key performance indicators makes financial reports more relevant to shareholders.	1	2	3	4	5
38.	A private individual shareholder is at a disadvantage in understanding financial statements when compared to institutional shareholders.	1	2	3	4	5
39.	The reported accounting information contained in financial statements presents in a clear manner its economic message to the shareholder.	1	2	3	4	5
40.	Accounting terminology included in financial statements is well understood by shareholders.	1	2	3	4	5
41.	A higher degree of narrative or descriptive reporting assists shareholders in understanding financial statements.	1	2	3	4	5
42.	Educating the shareholder to read financial statements would enable him/her to understand the message of financial statements and make more informed investment decisions.	1	2	3	4	5
43.	Financial statements disclosures are too lengthy and complex to read.	1	2	3	4	5

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
44.	The Maltese investor is financially literate enough to understand financial statements.	1	2	3	4	5
45.	The message of financial statements should be clearly explained at the Annual General Meeting of the company.	1	2	3	4	5
46.	Shareholders are able to understand the information contained in financial statements but find it irrelevant or of little use with regards to investment decisions.	1	2	3	4	5
47.	A simple two or three page report with key information would suffice.	1	2	3	4	5
48.	Terms worded in Maltese would facilitate the user's understanding of financial statements.	1	2	3	4	5
49.	Including a glossary of technical terms in financial statements would enable shareholders to understand the message of financial statements.	1	2	3	4	5
50.	Financial statements appropriately communicate the limitations of financial reporting to shareholders.	1	2	3	4	5

SECTION 3: THE USE OF FINANCIAL STATEMENTS

51. Please rank (on a scale of 1 to 6) the following uses of financial statements in order of importance ('1' denotes the factor that is most significant while '6' denotes the factor that is least significant).

Decision making	_____
Predicting future cash flows	_____
Assessing stewardship	_____
Tax purposes	_____
Communicating financial information	_____
Valuation purposes	_____

SECTION 4: GENERAL INFORMATION (applicable for auditors)

52. Gender: ☐ Male
☐ Female

53. Age group: ☐ 21 – 30 years
☐ 31 – 40 years
☐ 41 – 50 years
☐ 51 – 60 years
☐ 61 + years

54. For how many years have you been holding a practicing certificate in auditing?
☐ 1 – 5 years
☐ 6 – 10 years
☐ 11 – 20 years
☐ 21 – 30 years
☐ 31 + years

55. Please indicate the work sector of your current full-time occupation (*tick as appropriate*):

a) Audit firm ☐
Area: Audit ☐
Accountancy ☐
Advisory services ☐
Management consultancy ☐
Tax/Legal ☐
Other, please specify _____
Firm Type:
Big-Four firm ☐
Other ☐

b) Sole practitioner ☐

56. Please include any other comments that you may have on the subject matter

QUESTIONNAIRE - SHAREHOLDERS

The following set of statements relate to the objectives and understandability of audited financial statements. Please encircle the number that reflects your view about each statement.

SECTION 1: THE MESSAGE OF FINANCIAL STATEMENTS

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
1.	The objective of financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.	1	2	3	4	5
2.	Financial statements are useful to enable shareholders to monitor the past performance of a company.	1	2	3	4	5
3.	Financial statements enable shareholders to predict future performance and future cash flows of a company.	1	2	3	4	5
4.	The objective of financial statements is to assist investors in making economic decisions - whether to buy, hold or sell their investment.	1	2	3	4	5
5.	The objective of financial statements is to present a true and fair view of a company's financial performance and financial position for a reporting period.	1	2	3	4	5
6.	Financial statements show whether a company is well managed.	1	2	3	4	5
7.	Financial statements show the efficiency with which a company is being run.	1	2	3	4	5
8.	Financial statements portray management's ability to economically use the resources entrusted to it.	1	2	3	4	5

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
9.	The objective of financial statements is to present a picture of the company's short-term performance.	1	2	3	4	5
10.	Financial statements provide information that enables investors to measure a company's long-term performance.	1	2	3	4	5
11.	The objective of preparing financial statements is to compute and present the profit earned by a company during a reporting period.	1	2	3	4	5
12.	The audit of financial statements by an independent auditor ensures that financial statements are free of material errors, frauds or irregularities.	1	2	3	4	5
13.	The change in focus from the income statement (emphasising income and expenditure) to the balance sheet (emphasising the assets and liability approach) provides more relevant information to investors.	1	2	3	4	5
14.	The use of fair values and mark-to-market accounting provides more relevant information than historical cost accounts.	1	2	3	4	5
15.	Financial statements provide assurance to shareholders that a company has complied with the applicable rules and regulations.	1	2	3	4	5
16.	The objective of financial statements is to ensure the accuracy and legitimacy of accounting records.	1	2	3	4	5
17.	Financial statements enable shareholders to assess management's stewardship of the company's assets.	1	2	3	4	5
18.	Financial statements show whether a company is a good investment or not.	1	2	3	4	5
19.	Financial statements show whether a company is a going concern.	1	2	3	4	5
20.	Financial statements show whether a company has a sound internal control structure.	1	2	3	4	5

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
21.	The inclusion of an audit report enhances the credibility of a company's financial statements.	1	2	3	4	5
22.	The inclusion of other reports (e.g. chairman's statement) provides useful information to the shareholders.	1	2	3	4	5
23.	Financial statements present an accurate and complete picture of a company's financial performance and financial position.	1	2	3	4	5
24.	An exercise of judgement is required in the preparation of financial statements.	1	2	3	4	5
25.	Financial statements can achieve various objectives with the same set of figures.	1	2	3	4	5
26.	An unqualified audit report implies that the financial statements are free from fraud.	1	2	3	4	5
27.	The primary use of financial statements is for tax purposes.	1	2	3	4	5
28.	The primary use of financial statements is for use by bankers and providers of finance.	1	2	3	4	5

SECTION 2: THE UNDERSTANDABILITY OF FINANCIAL STATEMENTS

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
29.	Audited financial statements are the most important communications link between a company and its shareholders.	1	2	3	4	5
30.	The company's financial statements are read by shareholders.	1	2	3	4	5
31.	The company's financial statements are understood by shareholders.	1	2	3	4	5

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
32.	The present format and content of financial statements is adequate to meet investors' requirements.	1	2	3	4	5
33.	Financial statements are too complex to be understood.	1	2	3	4	5
34.	The message of financial statements is 'lost' in the clutter of lengthy disclosures and regulatory terminology.	1	2	3	4	5
35.	The use of graphs in financial statements would make financial statements more understandable.	1	2	3	4	5
36.	Educating investors would help investors better understand the scope and limitations of financial statements.	1	2	3	4	5
37.	The inclusion of key performance indicators makes financial reports more relevant to shareholders.	1	2	3	4	5
38.	A private individual shareholder is at a disadvantage in understanding financial statements when compared to institutional shareholders.	1	2	3	4	5
39.	The reported accounting information contained in financial statements presents in a clear manner its economic message to the shareholder.	1	2	3	4	5
40.	Accounting terminology included in financial statements is well understood by shareholders.	1	2	3	4	5
41.	A higher degree of narrative or descriptive reporting assists shareholders in understanding financial statements.	1	2	3	4	5
42.	Educating the shareholder to read financial statements would enable him/her to understand the message of financial statements and make more informed investment decisions.	1	2	3	4	5
43.	Financial statements disclosures are too lengthy and complex to read.	1	2	3	4	5

		Strongly disagree	Disagree	Neutral	Agree	Strongly agree
44.	The Maltese investor is financially literate enough to understand financial statements.	1	2	3	4	5
45.	The message of financial statements should be clearly explained at the Annual General Meeting of the company.	1	2	3	4	5
46.	Shareholders are able to understand the information contained in financial statements but find it irrelevant or of little use with regards to investment decisions.	1	2	3	4	5
47.	A simple two or three page report with key information would suffice.	1	2	3	4	5
48.	Terms worded in Maltese would facilitate the user's understanding of financial statements.	1	2	3	4	5
49.	Including a glossary of technical terms in financial statements would enable shareholders to understand the message of financial statements.	1	2	3	4	5
50.	Financial statements appropriately communicate the limitations of financial reporting to shareholders.	1	2	3	4	5

SECTION 3: THE USE OF FINANCIAL STATEMENTS

51. Please rank (on a scale of 1 to 6) the following uses of financial statements in order of importance ('1' denotes the factor that is most significant while '6' denotes the factor that is least significant).

Decision making	_____
Predicting future cash flows	_____
Assessing stewardship	_____
Tax purposes	_____
Communicating financial information	_____
Valuation purposes	_____

SECTION 4: GENERAL INFORMATION (applicable for shareholders)

52. Gender: ☐ Male
☐ Female
53. Type of shareholder: ☐ Individual
☐ Institutional investor
☐ Other
54. Age group: ☐ 21 – 30 years
☐ 31 – 40 years
☐ 41 – 50 years
☐ 51 – 60 years
☐ 61 + years
55. What is your level of education?
☐ Primary
☐ Secondary
☐ Post-secondary
☐ Tertiary
56. Do you have formal education in financial accounting?
☐ Yes
☐ No

57. How long have you been a shareholder?

- ☐ 0 – 5 years
- ☐ 6 – 10 years
- ☐ 11 – 15 years
- ☐ 16 – 20 years
- ☐ 21 + years

58. How many companies do you invest in at any one time?”

- ☐ 1 company
- ☐ 2 – 5 companies
- ☐ 6 -10 companies
- ☐ 10 + companies

59. When do you find the financial statements most useful?

- ☐ As a continuing shareholder
- ☐ When you are about to buy shares
- ☐ When you are about to sell shares
- ☐ Never

60. Please include any other comments that you may have on the subject matter

*Thank you for your kind collaboration.
Please return the completed questionnaire in the enclosed self-addressed envelope.*

APPENDIX 2 - INTERVIEW SCHEDULE

INTRODUCTORY LETTER

Address

Date

Dear Participant,

I am currently a doctoral student at the School of Business and Economics at Loughborough University conducting research on financial reporting in Malta. The aim of this study is to investigate the views of auditors and shareholders in Malta on the objective of financial statements and the message being conveyed through audited general purpose financial statements. The outcome of this project should be of special interest to auditors, academics, policymakers and industry stakeholders seeking to maintain or enhance Malta's position in the financial reporting environment.

As an important stakeholder, your knowledge and valuable insights can assist me in achieving the study's objectives. I would greatly appreciate if could spend some time in answering some questions on the subject matter. The interview has nineteen questions and will take between 40 and 60 minutes. With your permission, I will record the conversation and take notes during the meeting.

The information acquired will be solely used for research purposes. The final results will be reported in the doctoral thesis and may be published in journals or presented at conferences. You are, however, assured of anonymity, and strict confidentiality. There will be no reference or indication, either directly or indirectly, to you or your firm. To ensure confidentiality, participants will be assigned a reference number or code. Data will be stored against this number/code rather than with reference to the names of participants. Any document or tape recording and any other form of individual identification will be destroyed immediately after the study has been completed. A summary of the final report will be made available to you once the study is concluded.

If you have further queries, you can contact me on norbert.tabone@um.edu.mt or you may contact Dr Andrew Higson (a.w.higson@lboro.ac.uk) who is my Loughborough supervisor.

Thank you once again for your time and cooperation.

Yours sincerely,

Norbert Tabone

THE INTERVIEW SCHEDULE - AUDITORS AND SHAREHOLDERS

Participant's code: _____
Participant's firm type: _____ (*applicable for auditors only*)
Participant's gender: _____
Interview date and time: _____
Interview location: _____
Interview duration: _____

Background information

This interview is part of the research for a thesis on financial reporting in Malta. All responses will be used for research purposes only. The interview follows the distribution of a questionnaire among auditors and shareholders in Malta aimed at conducting research on financial reporting in Malta.

General introductory question

1. Could you describe your involvement with audited general purpose financial statements? (*Q1*)

The objective of financial statements

2. What do you consider to be the objective of financial statements? (*Q2*)
3. What do you consider to be the main use of financial statements? (*Q3*)
4. "[T]he objective of primary financial statements is to provide summarised information about recognised assets, liabilities, equity, income, expenses, changes in equity, and cash flows that has been classified and aggregated in a manner that is useful to users of financial statements in making decisions about providing resources to the entity." (An interpretation of the IASB's objective by IFRS Foundation, 2013, p.12).

How far do you agree with this statement? (*Q4*)

5. Stewardship is considered another reason for preparing financial statements. What do you understand by the word 'stewardship'? How well do the financial statements reflect management's stewardship? (*Q5*)
6. Income tax considerations are often also viewed as another primary purpose of preparing financial statements. What are your views on this? (*Q6*)

7. Analysts and investors often wish to predict an entity's future cash flows - how useful do you think the financial statements are for this purpose? (Q7)

Message in the financial statements

8. How far do you think that users understand the information contained in audited financial statements? Do they actively use this information? (Q8)
9. Do you think that financial statements are precise, accurate and correct? (Q9)
10. What do you understand by the phrase 'a true and fair view'? (Q10)
11. Do audited financial statements really reflect the performance (past and/or future) of the reporting entity?
- i. If auditors do not comment about economy, efficiency and effectiveness in their audit report, then how can performance be assessed?
 - ii. Can financial statements provide all the information that users may need for assessing both short-term and long-term performance? (Q11)
12. What are your views about the move from the "income and expenditure view" of the financial statements to the "assets and liabilities approach"? (Q12)
13. What is your opinion on the increased focus on fair values and mark-to-market accounting as opposed to historical cost accounting? (Q13)
14. To what extent do you think that the present format and content of financial statements is adequate to meet the users' requirements? (Q14)

The Maltese environment

15. Are there any characteristics of a European small island state such as Malta that can influence the objective of financial statements? (Q15)
16. Is the message contained in financial statements being understood by users in Malta? (Q16)
17. What factors do you think can distort the message being communicated in financial statements to shareholders in Malta? (Q17)
18. What specific information do you think investors and other stakeholders in Malta want to be included in financial statements? (Q18)
19. Do you have any other comments you would like to add on the subject? (Q19)

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