International Journal of Science and Research (IJSR)
ISSN: 2319-7064
ResearchGate Impact Factor (2018): 0.28 | SJIF (2018): 7.426

Extended Audit Report and Audit Expectation Gap - A Case Study of FTSE Companies of United Kingdom

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Abstract: ***New audit reporting standard (ISA 701) providing for extended audit report disclosing key audit matters in independent auditor's report has been mandated in United Kingdom [Audit standard board of UK has mandated the adoption of ISA 701 from the effective date – December 15, 2016] for all the listed companies. With this independent auditor's report is no more a pass-fail model, instead it has more elaborative information content in the form of key audit matters. The KAMs - key audit matters to be disclosed in the EAR -extended audit report will surely assist different stakeholders in decision-making. The research work was carried out by using the annual reports of six companies from FTSE – 350 of United Kingdom and it was examined how the new auditor's reporting standard requiring the presentation of extended audit report can reduce the audit expectation gap and the impact of audit firm rotation on reducing audit expectation gap. For this, the financial risk issues or matters covered in audit committee report were considered as audit expectation from independent auditor. A comparison of financial risk issues disclosed in audit committee report (considered as benchmark for audit expectation from independent auditor) with the KAMs disclosed in EAR revealed that there was a wide audit expectation gap for all the six companies included in the study. Audit firm rotation was also not effective in improving the disclosure of KAMs in EAR. For all the six companies audit firm rotation has shown declining ACR percentage (proportion of common financial risk matters in both the reports to the financial risk matters disclosed in audit committee report) -an indicator of high audit expectation gap. Thus, it was concluded that audit firm rotation was not much effective in presenting the KAMs as per the expectation of audit committee. Further, it was concluded that audit firm rotation for all the six companies was not effective in eliminating audit expectation gap; rather it widened the audit expectation gap.***

Keywords: Extended audit report, Key audit matters, Audit committee report, Audit expectation gap

1. The Background

Extended Audit Report

The after math of financial crisis prompted the regulators across the globe to improve independent auditor's report. United Kingdom – UK is one of the leading country that mandated a new format of audit report and initiated the implementation of International Standard on Auditing (ISA) 701. The primary focus of this auditing standard (ISA 701) combined with effect of ISA 700 is on EAR - extended audit report and inclusion of KAMs -key audit matters in independent audit's report. ISA 701 envisage the auditor's responsibility to communicate key audit matters in the auditor's report. Issue of KAMs is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication. ISA 701 provides for KAMs to be disclosed in the extended audit report. The primary purpose of communicating KAMs is to provide additional information to existing and prospective users of the financial statements to assist them in understanding these matters before taking any decision based on audited financial statements. The KAMs disclosed in the auditor's extended audit report will surly reflect auditor's professional judgment and broaden the scope and authenticity of audit report resulting into enhanced validity of audited financial statements.

At present audit reports of listed as well unlisted companies/firms are mostly standardized, and the audit report presented as an integral part of the annual report disclose only a limited facts. These limited facts only authenticate the financial statements and scarcely provide any significant information to different stakeholders. Current format of audit report is none other than pass-fail model. The reason for this limited informativeness is due to the fact that audit report format has changed little since 1940.To improve the informativeness of audit report, audit standard setting boards across the globe are consistently working on the improvement of audit standards to include a significant volume of information in independent auditor's report with the aim to provide quality input for decision makers – stakeholders. This has resulted in the issuance of ISA 701 – EAR (extended audit report) and inclusion of KAMs (key audit matters) in independent auditor's report.

Every company has the onus of apprising different stakeholders about its corporate affairs – financial position, governance related issues, report of business segments and related matters by means of annual report. Disclosure of auditor's report in the annual report along with financial statements validates the authenticity of these financial statements.

Provisions of ISA 701 are effective for audits of financial statements for periods ending on or after December 15, 2016, however companies may go for voluntary adoption of these provisions prior to the effective date. This auditing standard has been implemented in UK – United Kingdom from the given effective date and the auditors shall use their judgment in deciding about the matters known as key audit matters - KAMs to be communicated in the auditor's report while performing the audit assignment. In making, this determination the auditor shall take their best judgment in preparing extended audit report comprising of KAMs in communicating with those charged with governance issues.

Therefore communicating key audit matters – KAMs in the independent auditor's report has been announced as an auditing standard called ISA 701 issued by the International Auditing and Assurance Standards Board (IAASB) in 2015, with an effective date of December 15, 2016. Following the path UK auditing board mandated the adoption of this audit standard from above mentioned effective date.

Audit Committee Report

The provisions of good corporate governance provide the constitution of an independent audit committee by the board of directors of the company to enhance the informational content of financial statements of the company. The audit committee derives its powers from board of directors of the company, therefore it reports to board of directors by reporting significant financial and reporting issues. The audit committee plays a key role in assisting the board to fulfill its oversight responsibilities in the areas like financial reporting, internal control system risk management systems and internal and external audit functions. Therefore, the issues disclosed in audit committee report can be considered as a proxy to quality of audited financial statements but these may not be taken as a substitute for independent auditor's report. Audit committee must schedule at least one meeting in a year with the independent auditor, this meeting to be held without the presence of management (board) of the company. The purpose of such meeting is to discuss about the matters of significant audit process and significant audit issues depending on the nature of entity.

The independent auditor performs the audit to form an opinion about financial statements/reports. Whether these financial statements/reports comply with the requirements of the companies act and audit standard or not. Further, the independent auditor is required to give its true and fair views on the financial statements of the entity. Whereas, the audit committee reviews the scope of the audit and oversees the relationships with the auditors. The important financial risk issues as perceived by audit committee and disclosed in ACR - audit committee report can be taken as a proxy for expectation from independent auditor's report now construed as EAR – extended audit report disclosing KAMs – key audit matters.

Genesis of the Research

Both audit committee report and provisions of ISA 701 aim at enhancing the quality of audited financial statements. Provisions of ISA 701 focus on the increased informational content of independent auditor's report. The KAMs disclosed in EAR must correspond with the significant financial issues disclosed in the audit committee report. This fact prompted the researcher in undertaking the ensuing research work titled "Extended Audit Report and Audit Expectation Gap – A Case Study of FTSE Companies of United Kingdom". The research work focuses on – a consistency check of KAMs disclosed by different audit firms and a comparison of these KAMs with the significant financial issues disclosed in audit committee report leading to the identification of audit expectation gap. Further, the research work analyses the relationship between audit firm rotation and audit expectation gap.

2. Review of Literature

Audit quality is measured as the propensity of the auditor to issue a GCO – going concern opinion (Jackson, A.B., Moldrich, M. and Roebuck, P., 2008)[i]after controlling for other factors that might affect this decision. The model used includes tenure, the client financial risk, total assets, ratio of liabilities to assets, percentage change in the book value of net assets over the year. Audit quality increases with audit firm tenure, when represented by the propensity to issue a going-concern opinion.

Rotation of auditor has significant impact on audit quality and in minimizing audit expectation gap (Zeff, S.A., 2003)[ii]. The research focused on analyzing the effect of auditor's rotation on audit quality. Du Pont systematically rotated its external audit firm between 1910 and 1954. Du Pont's reason for audit firm rotation is to ensure auditor independence, give all the stakeholders the information regarding the true condition of the company and prevent or expose collusion among officers. In the 1940s, two main issues were raised by Du Pont's auditors. They questioned Du Pont's practice of not allocating the balance in its combined surplus account to earned surplus, paid-in surplus and surplus arising from revaluation of assets and retrospective allocations of various charges and credits.At the end, Du Pont hired PWC as permanent external auditor, because of the increasing size and complexity of Du Pont and its extensive overseas operations.

Use ERC -earnings response coefficient as a proxy for investor perception of audit quality (Cameran, M., Prencipe, A. and Trombetta, M., 2016)[iii] accordingly accounting conservatism and audit quality tends to increase in the last engagement period preceding mandatory audit firm rotation. Perceived audit quality tends to be higher in the third (last) three-year period of engagement. Regression model was used to test accounting conservatism as a proxy to audit quality.

Audit firm rotation can instrumental in improving audit quality (Corbella, S., Florio, C., Gotti, G. and Mastrolia, S.A., 2015)[iv]. The study was carried out using the data of all listed Italian companies, from 1998 to 2011, audit quality improves following audit firm rotation but only for companies audited by a non-Big 4 audit firm, after controlling for audit partner rotation and other variables. Additionally, following audit firm rotation, the total amount of fees paid to the auditor was lower for companies audited by a Big 4 and unchanged for companies audited by a non-Big 4 audit firm.

Mandatory rotation reduces auditor incentives to protect reputation (Ruiz-Barbadillo, E., Gómez-Aguilar, N. and Carrera, N., 2009)[v]; therefore, these findings are consistent with prior studies suggesting that mandatory rotation may have adverse effects on audit quality. The research also concluded that mandatory rotation fails to enhance auditor independence; market-based incentives may be more effective in safeguarding auditor independence than regulatory measures. Mandatory rotation may in fact harm independence.

EAR does not reveal any additional information beside that already provided in the financial statements and the notes of the financial statements but point out to the possible usefulness of the going concern opinion (Dobija, D., Cieślak, I. and Iwuć, K., 2013).[vi]In auditor's views, audit report provides comfort and the feeling of safety that the information provided in the annual report is correct. They also stressed the importance of audit report to the audit committees and the shareholders. As to the improvement in the information value of the report, most auditors agree that the most preferred format of the report is a standardized format of the report extended by additional information. EAR may create problems of comparability and setting benchmarks. In addition, there is possibility of providing information on the auditor's discussion and analyses. All auditors agree that no value if added when the information on the audit team and engagement statistics is included, since they are included in other reports.

Investors pay more attentions to disclosures related to KAMs communicated in the auditor's report (Sirois, L.P., Bédard, J. and Bera, P., 2018)[vii]. When KAMs are included in the auditor's report, investors tend to pay more attention to the KAMs related part than other parts in the annual report. This implies that KAMs can improve information search and acquisition efficiency by reducing less relevant disclosures.

As regards the ineffectiveness of EAR (Gutierrez, E., Minutti-Meza, M., Tatum, K.W. and Vulcheva, M., 2018) [viii]there is no evidence that the rule changes (require to prepare expanded auditor report) had a significant effect on investors' reaction, audit fees, and audit quality. They do not find that variation in the expanded reports' content has affected these outcomes. Collectively, their evidence is consistent with the expanded auditor's report providing little incremental information to investors.

3. Research Profile

The research design was qualitative - empirical in nature with following objective:

- Check the consistency of EAR with ACR
- Identify audit expectation gap.
- How EARs change with the change in audit firm.

The research work was undertaken using annual reports of FTSE 350 companies using two stage sampling process. In total six companies out of all the companies included in FTSE 350 were included in the study. In the first stage, two industries were selected by draw of lots these were food& drug retailers industry and construction industry. The three companies from each of these two industries were selected who had implemented ISA 701 much earlier than the effective date. The six companies included in the research were Tesco, Sainsbury's and Ocado from food & drugs retailers industry and Balfour Beatty, Crest Nicholson and Persimmon were from construction industry. All these companies had implemented ISA 701 voluntarily much earlier than the effective date.

Data collected was secondary in nature, from annual reports of the sample companies for the period from financial year 2014 to 2018. The data so collected was analyzed using appropriate statistical tools like method of tabulation, percentage and statistical tools to test the hypothesis. The findings of the research are subject to the limitations of samplings method and secondary data. The findings are applicable in the circumstances and situations, which prevailed during the study period i.e. 2014 to 2018 therefore these, may not find generalized application.

4. Analysis of Facts

The data collected from the annual reports of sample companies for the period from financial year 2014 to 2018, were analyzed to achieve research objectives, these are presented below:

Consistency of EAR and ACR

The purpose of both EAR – extended audit report and ACR - audit committee report is to enhance the information contents and quality of financial statements. A comparison of contents disclosed in EAR and ACR helped in checking the consistency of EAR with ACR

Table 1: Consistency Check for Companies of Food & Drugs Retailers Industry

	Sainsbury's		Tesco		Ocado	
Year	KAM %	ACR %	KAM %	ACR %	KAM %	ACR %
2014	50	60	17	17	100	75
2015	80	80	50	50	100	100
2016	66	43	63	45	100	80
2017	60	38	50	40	33	20
2018	60	33	67	37	33	40

Note: KAM percentage means common risks in both reports / Total no. of KAMs in EAR, and ACR percentage means common risks in both reports/no. of significant financial issues in ACR

Interpretation: The analysis of the table reveals a disjoint movement in both EAR and ACR. For Sansbury's. In the year 2014 the ACR percentage (proportion of common risk in both the reports to number of significant financial issues given in ACR) was 60%, this declined to 33.33% in the year 2018. This shows that after the adoption of EAR, the level of disclosure in ACR has decreased. Whereas, KAM percentage(proportion of common risks in both report to total number of KAMs in EAR)has almost remained consistent during this period. For Tesco also the proportion of KAM percentage has increased from 17% in 2014 to 67 % in 2018, at the same time proportion of ACR percentage has also increased to 37% in 2018 from 17% in 2014. Whereas KAM % for in case of Ocado has decreased to 33% in 2018 as compared to 100% in 2014 at the same time ACR % has also declined to 40% in 2018 from 75% in 2014.

The overall impression is that after the adoption of new audit standard – ISA 701 for two companies out of the three companies of food & drug retailer industry included in sample has been effective, as the proportion of KAMs covered in EAR has remained either unchanged or increased. At the same time for all the three companies proportion of financial risk issues covered in ACR has declined indicating declined efficiency of ACR.

Table 2: Consistency Check for Companies of Construction Industry

	Balfour Beatty		Crest Nicholson		Persimmon	
Year	KAM %	ACR %	KAM %	ACR %	KAM %	ACR %
2014	60	30	100	100	100	100
2015	50	22	100	67	100	100
2016	100	25	100	60	100	67
2017	100	25	90	50	67	50
2018	90	20	100	40	67	50

Note: KAM percentage means common risks in both reports / Total no. of KAMs in EAR, and ACR percentage means common risks in both reports/no. of significant financial issues in ACR

Interpretation: The analysis of the table reveals a disjoint movement in both EAR and ACR. For Balfour Beatty in the year 2014 ACR % was 30%, this declined to 20% in the year 2018. This shows that after the adoption of EAR, the level of disclosure in ACR has decreased. Whereas, level of disclosure of KAMs corresponding to the significant financial issues disclosed in ACR has increased during this period to 90% in 2018 from 60% in 2014. For Crest Nicholson the proportion of KAM percentage has almost remained constant to 100% during all these years, but ACR percentage has declined to 40% in 2018 from 100% in 2014. Whereas KAM percentage of Persimmon has decreased to 67% in 2018 as compared to 100% in 2014 at the same time ACR percentage has also declined to 50% in 2018 from 100% in 2014.

The overall impression is that after the adoption of new audit standard – ISA 701 for two companies out of the three companies of construction industry included in sample has been effective, as the proportion of KAMs covered in EAR has remained either unchanged or increased. At the same time for all the three companies proportion of financial risk issues covered in ACR has declined indicating declined efficiency of ACR.

Analysis of Audit Expectation Gap

To analyze audit expectation gap, significant financial risks covered in ACR – audit committee report can be considered as expectation of board of directors of the company because the audit firm takes the directions for audit assignment from audit committee. The KAMs – key audit matters disclosed in EAR – extended audit report as the performance measurement for EAR. A comparison of number of KAMs disclosed in EAR and number of financial risks covered in ACR helps in finding out the expectation gap, if any. The expectation indicators can be drafted as follows:

Low Expectation Gap - A high ACR percentage (percentage of common financial risk matters to the total number of financial risk matters covered in ACR) indicates that KAMs included in EAR are in line with the expectation of audit committee. This combined with low KAM percentage (percentage of common risk maters to the total number of KAMs covered in EAR) shows that EAR contains wide range of information in the form of KAMs as compared to the expectation of audit committee.

High Expectation Gap - A low ACR percentage (percentage of common financial risk matters to the total number of financial risk matters covered in ACR) indicates that KAMs included in EAR are not in line with the expectation of audit committee. This combined with low KAM % (percentage of common risk maters to the total number of KAMs covered in EAR) shows that EAR contains extensive information as compared to the expectation of audit committee indicating high level of informativeness of EAR.

A combined interpretation of both table number 1 and 2 shows that for all the six companies ACR percentage over these five financial years i.e. from 2014 to 2018 has declined leading to the interpretation that EAR left high audit expectation gap. At the same time KAM percentage was increasing this indicates that EAR was not disclosing any unique KAM beyond the expectation of audit committee. This leads to the conclusion that level of KAM disclosure in EAR was not much effective. In addition, there is high level of audit expectation gap in these six sample companies.

Analysis of Audit Firm Rotation and Audit Expectation Gap

Rotation of audit firm is considered as a tool to improve the quality and information content of independent auditor's report. Company wise analysis of audit firm rotation presented below reveals how far audit firm rotation has contributed in the effectiveness of EAR in reducing expectation gap.

Table 3: Audit Firm for Companies of Food & Drugs Retailers Industry

	Sainsbury's		Tesco		Ocado	
Year	Audit Firm	ACR %	Audit Firm	ACR %	Audit Firm	ACR %
2014	PWC	60	PWC	17	PWC	75
2015	PWC	80	PWC	50	PWC	100
2016	EY	43	Deloitte	45	PWC	80
2017	EY	38	Deloitte	40	Deloitte	20
2018	EY	33	Deloitte	37	Deloitte	40

Note: ACR percentage means common financial risks of matters in both reports/no. of significant financial issues in ACR.

(PWC – Price Waterhouse Corporation, EY – Earnest & Young)

Interpretation: The table given above shows ACR percentage and audit firm across all the financial years covered in the study for food & drugs retailers industry. In all the three companies a change of audit firm from PWC to other audit firm (EY and Deloitte) has shown declining ACR percentage -indicating high audit expectation gap. This shows that PWC was more effective in presenting the KAMs as per the expectation of audit committee as compared to other audit firms replacing PWC. Therefore, it can be concluded that audit firm rotation in case of food & drug retailer industry was not effective; rather it widened the audit expectation gap.

Table 4: Audit Firm for Companies of Construction Industry

	Balfour Beatty		Crest Nicholson		Persimmon	
Year	Audit Firm	ACR %	Audit Firm	ACR %	Audit Firm	ACR %
2014	Deloitte	30	KPMG	100	KPMG	100
2015	Deloitte	22	PWC	67	KPMG	100
2016	KPMG	25	PWC	60	EY	67
2017	KPMG	25	PWC	50	EY	50
2018	Deloitte	20	PWC	40	EY	50

Note: ACR percentage means common financial risks or matters in both reports/no. of significant financial issues in ACR.
(KPMG –Klynveld Peat Marwick Goerdeler)

Interpretation: The table given above shows ACR percentage and audit firm across all the financial years covered in the study from construction industry. It reveals that audit firm rotation resulted in increased expectation gap as we observe that ACR percentage has declined after the rotation of audit firm. This leads to the interpretation that audit firm rotation has negative effect on audit expectation gap.

5. Conclusion

The primary purpose of extended audit report (ISA-701) implementation is to enhance the information content of independent auditor's report. The facts presented in analysis section indicate that after the adoption of EAR – extended audit report by the sample companies the level of information content of independent auditor's report has increased. Now independent auditor's report is not a pass-fail model instead it provides KAMs – key audit matters. The KAMs presented in EAR provide necessary input for decision making by different stakeholders.

Audit committee is considered as a linking pin between board of directors of the company and independent auditor of the company. In a way audit, committee specifies the scope of audit engagement/assignment. The financial risk issues or matters covered in audit committee report can be considered as audit expectation (considered as standard to evaluate KAMs disclosed in EAR) from independent auditor. Thus, the financial risk issues covered in audit committee report (ACR) can be taken as performance standards for EAR given by independent auditor.

The analysis of facts of all the six sample companies helped in achieving research objectives. A comparison of ACR percentage - common financial risks or matter in both reports to number of significant financial issues in ACR was taken as benchmark for audit expectation gap. Low ACR percentage indicated high audit expectation gap. For all the six companies across all the financial years from 2014 to 2018 ACR % has declined leading to the interpretation that KAMs covered in EAR left high expectation gap.

Audit firm rotation was also not effective in improving the disclosure of KAMs in EAR. In all the six companies audit firm rotation has shown declining ACR percentage - indicator of high audit expectation gap. This shows that audit firm rotation was not much effective in presenting the KAMs as per the expectation of audit committee. Therefore, it can be concluded that audit firm rotation in case of both of these industries was not effective; rather it widened the audit expectation gap.

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