

Savka Vučković Milutinović
University of Belgrade
Faculty of Economics
Department for Accounting and Business
Finance

ANALYSIS OF MODIFICATIONS TO AUDITOR'S OPINION ON FINANCIAL STATEMENTS OF LISTED COMPANIES IN SERBIA

Analiza modifikacija revizorskog mišljenja o finansijskim
izveštajima listiranih kompanija u Srbiji

Abstract

In this study we shed light on the quality of financial statements of listed companies in Serbia by analyzing auditors' opinions expressed in independent auditors' reports for the 2015-2017 period. We revealed that the percentage of modified audit opinions was well above the level in developed countries, confirming weak market and regulatory incentives to improving financial reporting practices. We analyzed the propensity of different audit firms to issue modified audit opinions, as well as underlying financial reporting matters that led to modifications. The analysis revealed that the impairment of assets is the main reason for auditors' modifications, reflecting unfavorable economic reality of many companies. By expanding our analysis to the emphasis of matter paragraph in audit reports with modified, as well as unmodified audit opinion, we also provided a complete insight into the extent of appearance of the going concern issue among the listed companies.

Keywords: *auditor's report, modified audit opinion, emphasis of matter, listed companies.*

Sažetak

U ovom istraživanju smo ukazali na kvalitet finansijskih izveštaja listiranih kompanija u Srbiji putem analize revizorskih mišljenja iskazanih u revizorskim izveštajima za period od 2015. do 2017. godine. Identifikovali smo da je procenat modifikovanih mišljenja značajno iznad nivoa karakterističnog za razvijene zemlje, što potvrđuje da su tržišni i regulatorni podsticaji ka unapređenju praksi finansijskog izveštavanja nedovoljni. Analizirali smo sklonost različitih revizorskih firmi ka izdavanju modifikovanog mišljenja kao i relevantna pitanja u finansijskom izveštavanju koja su uzrok modifikacijama. Otkrili smo da je obezvređenje sredstava pojedinačno najzastupljeniji razlog za modifikacije revizorskog mišljenja, što je refleksija nepovoljne ekonomske realnosti mnogih kompanija. Šireći analizu na pasus skretanja pažnje u revizorskim izveštajima sa modifikovanim, kao i nedomifikovanim mišljenjem, pružili smo kompletnu sliku prisutnosti pitanja vezanih za nastavak poslovanja u doglednoj budućnosti.

Ključne reči: *revizorski izveštaj, modifikovano revizorsko mišljenje, skretanje pažnje, listirane kompanije.*

Introduction

External audit is accepted worldwide as an integral part of the financial reporting system, providing all stakeholders with the necessary assurance that financial statements are fairly presented. Although the process of auditing requires considerable efforts, the final and only outcome of auditing that is available to external users of financial statements is the auditor's report. Not surprisingly, the accounting profession, as well as regulators, pay special attention to the form and content of the auditor's report. There are a lot of desirable attributes that this report is expected to achieve, but it is not easy to balance them all and some trade-offs are unavoidable. Concise and standardized auditor's report has for years been seen as the most advantageous, since it prevented misunderstandings and contributed to comparability and consistency. However, communicative value of auditor's report was not sufficiently exploited, leaving its users dissatisfied with the content of the report. This has induced radical changes in the audit report model resulting in a more relevant report, primarily as a consequence of introducing the key audit matter paragraph which provides additional information to the intended users of financial statements and consequently reduces information asymmetry between auditors and users. The benefits of the auditor's report that is less standardized and more tailored to the specifics of engagement are expected to overcome the costs related to its implementation. Yet the new model has only recently been applied and its value still has to be confirmed in practice.

Although the latest change in the auditor's report is very important, its key part has always been the auditor's opinion. In case of unmodified opinion, however, additional information expressed through key audit matters increase usefulness of auditor's report to a great extent. In his survey that preceded the introduction of key audit matters, Carcello found that 91% of respondents, representatives of different investment organizations, did not even read the unmodified auditor's report [2, p. 24]. The situation is completely different when modified opinion is expressed by auditors, since this is a clear signal of deterioration of the quality of financial statements. Auditors issue a modified audit opinion (MAO) when they identify

material misstatements in financial statements or when, due to a limitation of the scope of the audit, they cannot conclude that financial statements are free from material misstatements. According to the International Standards on Auditing (ISAs), there are three types of MAOs: qualified, adverse and disclaimers of opinion.

Unlike developed countries, where MAOs are treated seriously by both investors and regulators and, consequently, appear relatively rare in practice, the frequency of MAOs in emerging economies is not low. That does not come as a surprise, since unreliable financial reporting is often an issue in emerging economies. In those circumstances, external auditing came to the fore as the most important mechanism to communicate to the public whether financial statements presented the financial position and performance of the reporting entity (un)fairly. For these countries, examination of trends in auditor reporting and of the nature of issued modifications, coupled with underlying reasons for their incidence, could help to illuminate the state of and gaps in good financial reporting practices. We examine in this paper auditor reporting on financial statements of listed companies in Serbia, focusing on MAOs, with the intention to reveal their frequency, issuance by different audit firms, and financial reporting issues that were the main drivers of modifications. Besides modifications, we also examine what type of matters auditors commonly emphasize in their reports.

Incidence of MAOs

The credibility of financial reporting is extremely important for public interest entities (PIEs), since these entities are characterized by "a large number and wide range of stakeholders" [10, p. 119]. Although the determination of PIEs varies across countries, the listed companies are undisputedly part of PIEs worldwide. However, it is also common that large entities and some regulated entities (e.g. banks, pension funds) are treated as PIEs. According to the new EU Audit Directive, the definition of PIEs includes entities whose securities are traded on a regulated market, credit institutions and insurance undertakings, but also provides for the possibility for member states to designate other entities as PIEs, considering primarily the

nature of their business or their size [6, Article 2, Point 13]. External audit of financial statements is mandatory for PIEs, since it provides an independent and competent assurance that financial statements present the financial position and performance of the audited entity fairly, which leads to lower exposure of stakeholders relying on these financial statements in making their decisions to information risk.

It is, however, of great concern if a PIE receives a MAO, which means that its financial statements contain a material misstatement or that auditors could not obtain evidence that financial statements were free of material misstatements. In any of these cases, the reliability of financial statements is seriously undermined, as well as the investor's confidence in financial statements, which could lead to unfavorable consequences for the audited entity, primarily in terms of availability and financing cost. Due to their role in ensuring stability, regulatory authorities also have a keen interest in PIEs regulated by them not receiving MAOs. It is to be expected then that MAOs are not frequent in the segment of PIEs, which is confirmed in many developed economies. In the USA, the regulation of listed companies imposes tough requirements in respect of the preparation of financial statements, treating financial statements which are not in accordance with the generally accepted accounting principles as misleading or inaccurate. Consequently, the Securities and Exchange Commission (SEC) does not accept financial statements regarding which auditors express MAOs [16, E2]. In an earlier research in the UK, Lennox found that only 2.96% of listed companies received MAOs. It should be noted that he also included clean opinions in MAOs if they were accompanied by auditors' emphasis of some accounting issues; hence, the proportion of real MAOs was actually under 2% [13, p. 328]. Gassen and Skaife explored MAOs in public listed companies in Germany, Austria, Switzerland, France and the UK. During the 1999-2000 period the average modified audit opinion rate for these countries was only 1.23% [7, p. 873]. Carson et al. show that in Australia the percentage of MAOs for listed companies increased from 2.3% to 4.8% in the 2005-2010 period and then reduced to 3.4% in 2013 [3, p. 233].

The situation is completely different in the emerging markets where market forces and regulatory infrastructure are still not strong enough to sufficiently stimulate improvement in the quality of financial reporting and auditing. Lin et al. researched MAOs in listed companies in China over the 1992-2009 period and found that the average proportion of MAOs (including clean opinions with emphasis of matter) was 11%, reaching a peak of 19.9% in 1999 [15, p. 137]. In Croatia, the proportion of listed companies receiving MAOs during the 2008-2014 period was 28 percent on average [1, p. 789]. In our study we wanted to reveal the frequency of MAOs in listed companies in Serbia. The initial sample consisted of all companies included in the regulated market at the Belgrade Stock Exchange over a three-year period from 2015 to 2017. This market comprises prime listing, standard listing and open market. For each year we eliminated from the sample those companies that delisted from the regulated market before December 31st that year, since they did not present part of this market at the year end and did not need to prepare financial statements following the rules for listed companies.

We collected audit reports of targeted companies from the database of financial statements maintained by the Serbian Business Registers Agency. The total of 112 audit reports were hand-collected. Table 1 presents the frequency of different types of audit opinions that the listed companies received. It is clear that the proportion of MAOs is very high. It was above 20% in 2015, increasing to a peak of 42.4% in 2016, after which it reduced to 32.3% in 2017. The average in the given period was 30.4%. What is even more striking, there are a few adverse opinions issued for the companies in the regulated market. These results indicate that the regulation framework is not stringent with regard to the quality of financial reporting. According to the Belgrade Stock Exchange rules, it is allowed for a company to receive a qualified opinion and still be on prime or standard listing, while no requirement is imposed in relation to the type of audit opinion for companies included in the open market, making it possible for them to receive adverse opinion.

It is generally considered that the issuing of MAOs depends primarily on two factors: the presence of material

Table 1: Distribution of different types of audit opinions in the Serbian regulated market in 2015-2017

	2015		2016		2017	
	Number	%	Number	%	Number	%
Unmodified opinion	38	79.2	19	57.6	21	67.7
Modified opinion	10	20.8	14	42.4	10	32.3
Qualified opinion	7	14.6	14	42.4	8	25.8
Adverse opinion	3	6.2	0	0	2	6.5
Total	48	100.0	33	100.0	31	100.0

misstatements in financial statements and audit quality, the latter representing the ability of auditors to detect a misstatement and their willingness to report it [15, p. 136]. Higher proportion of MAOs in the Serbian regulated market in comparison with developed and even some emerging economies could not be explained by a better quality of auditing. Although the quality of external auditing is an everlasting issue worldwide, the situation in Serbia regarding audit quality is more troublesome and, according to the report of the World Bank, in some instances it is reflected in “selling audit reports rather than audit services” [19, viii]. This unfavorable situation could be attributed to both weak market forces and weak regulatory environment. Contrary to developed economies, market forces of demand and supply in emerging markets are not strong enough to induce a high audit quality [4, p. 173]. That is also the case with Serbia where capital market is still thin and not sufficiently developed to create stronger demand for auditing services. On the supply side, scarce resources coupled with low balling practices also hinder the quality of audit service. It is certain that in these circumstances regulatory environment could play an important role in ensuring the audit quality. However, for many years Serbian audit market has been characterized by absence of any external quality control and consequent disciplinary actions for malpractices, as well as by low risk of auditors’ exposure to legal liabilities. Only in 2013 did the new Auditing Law introduce public oversight of external auditing. However, although external quality control was eventually established and the first disciplinary sanctions were imposed on external auditors in the last few years, we still have a long way to go to develop robust regulatory ambience which could enhance and safeguard quality in providing auditing services.

A better explanation for the high proportion of MAOs could be the low quality of financial reporting. Specifically,

it can be argued that financial statements in Serbia often do not present the financial position and performance of the relevant entities fairly. Moreover, since many auditors’ modifications could be avoided if companies corrected the identified misstatements, it seems that companies find that the benefits of making their financial statements look better surpass the costs of receiving MAO. It should also be noted that the lack of effective monitoring by regulators and weak legal enforcement with regard to the quality of financial reporting create a suitable environment for accounting manipulations. Even in the case of public companies, the Securities Commission does not contribute sufficiently to the integrity of the financial reporting system. Table 2 presents an interesting finding: some regulated companies repeatedly received MAOs, which reveals the absence of any pressure on them to align their financial statements with the financial reporting standards. Our analysis has shown that this behavior is not isolated, since out of the total number of MAOs in our sample only 4 (12%) were not repeated. Out of the companies that received MAOs 77% received it more than once, more than a half of companies received it twice, while 4 companies received a MAO each year in the given period. This also called into question the quality of corporate governance, especially audit committees, which are mandatory for public companies and expected to monitor the financial reporting process and contribute to its integrity.

Unwillingness of companies to correct their financial statements must be related to incentives for accounting

Table 2: Repeating MAOs in the Serbian regulated market in 2015-2017

Number of Received MAOs	Number of companies	% of companies
One	4	23.5
Two	9	53.0
Three	4	23.5
Total	17	100.0

manipulations. Similarly to other countries in continental Europe, companies in Serbia do not have diffused ownership, which means no emphasized agency problem between managers and owners. On the other hand, they intensively rely on funding from banks, which makes banks the most prominent users of financial statements. In their survey in Croatia, which is characterized by similar institutional settings, Barać et al. found that accounting manipulations were primarily directed toward three groups of users: suppliers, tax authorities and creditors [1, p. 800]. However, auditing is meaningful if MAOs have economic consequences. Thus, it should be expected that if manipulations are followed by a MAO, the intended effects of manipulations will be diminished.

Nevertheless, it seems that in Serbia, similarly to Croatia, MAOs have limited effects, which means that the companies with MAOs do not face increasing financial costs and constraints. It is interesting that banks, which should be considered sophisticated users, often ignored auditors' modifications, at least in lending decisions with lower exposures. Without banks' practices of adjusting financial statements with respect to identified misstatements (or raising financing costs in case of potential misstatements), companies derive more benefits if they do not correct their financial statements according to auditors' suggestions. In case of state-owned enterprises (SOEs) MAOs are even more harmless, since these entities mostly face soft budget constraints and count on government support and interventions in case of financial difficulties. Empirical evidence confirms that ignoring MAOs can result in extreme situations where SOEs distributed profits although they would have operated with a loss if they had followed auditors' modifications [19, p. x].

Since expectations with regard to financial reporting of public companies are generally the highest, unfavorable

situation on the Serbian regulated market represented in a high ratio of MAOs raises serious concerns about the quality of financial statements of other companies. In order to get insight into audit opinions for other companies, we decided to expand our research to 100 largest companies in Serbia. These companies are also PIEs due to their size, so the quality of their financial statements is very important. We used the list of the largest companies according to the level of their revenues, prepared by the Serbian Business Registers Agency for 2017. Since 5 of these companies have already been included in our previous sample as part of the regulated market, the final sample of large companies is 95. For three companies audit reports were not available for 2015, so 282 audit reports were analyzed in total. Table 3 reveals the distribution of different types of auditor's opinions among these companies.

In the study period, the percentage of MAOs was stable at around 21% to 22%. It is an undoubtedly high ratio, but surprisingly, with the exception of 2015 when the ratio of MAOs was at a similar level for both analyzed groups of companies, in 2016 and 2017 the ratio of MAOs was significantly higher for regulated companies. One of the possible explanations lies in the quality of audit, since greater scrutiny by auditors is generally expected for public companies owing to greater business risk faced by auditors in engagements performed for entities with public status. Although in Serbia this risk (e.g. loss from litigation, adverse publicity) is not as high as in developed countries, it is reasonable to assume that public companies are considered more demanding. Furthermore, more effort is needed when auditing public companies since, according to the Law on the Capital Market, the scope of auditing is extended for public companies and includes reporting to the board of directors and Securities Commission on the efficiency

Table 3: Distribution of different types of audit opinions for the largest companies in Serbia in 2015-2017

	2015		2016		2017	
	Number	%	Number	%	Number	%
Unmodified opinion	72	78.3	74	77.9	75	78.9
Modified opinion	20	21.7	21	22.1	20	21.1
Qualified opinion	14	15.2	16	16.8	14	14.8
Disclaimer of opinion	6	6.5	3	3.2	4	4.2
Adverse opinion	0	0	2	2.1	2	2.1
Total	92	100.0	95	100.0	95	100.0

of functioning of the internal audit, the systems of risk management and internal control [12, article 54].

Another factor contributing to the audit quality may be related to the mandatory criteria auditors must meet to be authorized to audit public companies. In the next section, we shall try to shed some light on the facts about audit firms included in the auditing of regulated market companies.

Analysis of MAOs with regard to audit firms

The Securities Commission is in charge of setting forth higher criteria for the audit of public companies in addition to general requirements imposed by the Law on Auditing. By determining additional criteria and producing a shortened list of auditors, the Commission intends to ensure that only auditors capable of performing demanding audits of public companies are included in such engagements. Table 4 shows audit firms with regard to their involvement in audit engagements on the regulated market.

An upward trend can be noticed in the number of audit firms. At the end of 2015, there were 63 audit firms, but until the end of 2017 Serbia had 69 registered audit firms. However, the number of audit firms authorized to audit regulated companies remained unchanged in 2016

Table 4: Involvement of audit firms in the regulated market

	2015	2016	2017
Number of registered audit firms in Serbia	63	67	69
Number of audit firms authorized to audit financial statements of companies in the regulated market (% of all audit firms)	25 (39.7)	25 (37.3)	19 (27.5)
Number of audit firms engaged in auditing financial statements of companies in the regulated market (% of authorized firms)	18 (72.0)	14 (56.0)	16 (84.2)

in comparison to 2015, but showed a relatively large drop in 2017. That should be related to the fact that the number of companies in the regulated market also decreased throughout the period. This especially refers to 2016, yet the effect of this shrinking of the regulated market was reflected in the number of auditors in 2017. It can also be seen that there was a very high proportion of authorized audit firms (44%) which did not have audit engagements in the regulated market in 2016. However, due to their leaving the market, in 2017 the proportion of engaged audit firms rose to 84%.

In order to get further insight into the characteristics of authorized firms, we examined the eligibility criteria for obtaining authorization stipulated by the Securities Commission. These criteria are primarily based on the size of the audit firm expressed in the minimum number of certified auditors and other employees in the audit department. It can be argued that such criteria are not stringent enough because they do not include some other aspects important for performing a high-quality audit in public companies, such as experience of auditors, longevity of the audit firm, its financial capabilities and, particularly, good results of the quality control reviews. In China, for example, audit firms must meet a comprehensive list of criteria which, among other things, includes the requirement of absence of any penalty or violation record in the last 3 years [20, p. 6]. In Serbia, however, as the result of deficiencies discovered after the Chamber of Authorized Auditors' quality control reviews, we discovered that specific sanctions (according to the Register of imposed sanctions) were imposed on four audit firms included in the regulated market without any effect on their eligibility for this market.

We also analyzed the propensity of different audit firms to issue MAOs. For this analysis, we took into consideration whether MAOs are issued by the Big 4 or other audit firms (non-Big 4). Table 5 presents the distribution of MAOs by audit firm type.

Table 5: Distribution of MAOs by audit firm type in 2015-2017

	2015			2016			2017		
	No. of audit reports (%)	No. of MAOs	% of MAOs	No. of audit reports (%)	No. of MAOs	% of MAOs	No. of audit reports (%)	No. of MAOs	% of MAOs
Big 4	16 (33)	1	6	12 (36)	4	33	7 (23)	0	0
Non-Big 4	32 (67)	9	28	21 (64)	10	48	24 (77)	10	42
Total	48 (100)	10	-	33 (100)	14	-	31 (100)	10	-

Two important findings can be observed from the statistics provided in Table 5. Firstly, the Big 4 audit firms accounted for a significantly lower number of clients on the regulated market than it is common in the developed countries. The research by Le Vourch and Morand shows that there is a difference between EU countries with regard to the market share of the Big 4 audit firms when considering the overall market for audit firms. However, as regards the listed companies, the 4 biggest audit firms maintain domination in most EU Member States [14, p. 110]. According to the report of the European Commission, the Big 4 have an average market share of almost 70% in the number of statutory audits of listed companies at the EU level [5, p. 9]. In Slovenia, all listed companies are audited by the Big 4 [17, p. 8]. In contrast, we find that in the Serbian regulated market only about one third of companies were audit clients of the Big 4 in 2015 and 2016, with decline to less than one fourth of companies in 2017, because of the falling mandates of KPMG, which had the highest market share of all the members of the Big 4.

The second finding is related to the share of MAOs in the total number of audit opinions issued by the Big 4 and non-Big 4 audit firms. In the study period, the percentage of MAOs issued by the Big 4 audit firms is lower than the percentage of MAOs issued by the non-Big 4. In 2017, the Big 4 did not issue any MAOs, but in 2015 and 2016 they issued 1 and 4, respectively. The non-Big 4 issued a vast majority of MAOs in the regulated market and a relatively high percentage of their clients received MAOs, ranging from 31% to 48%. At first glance, this result could be surprising. A lot of empirical studies, mainly concerning developed markets, show a strong positive association between the Big N affiliation and MAOs, which is explained by audits of higher quality performed by the Big N audit firms [8, p. 208]. However, lower propensity of the Big 4 to issue MAOs could be explained by their strategy to avoid riskier clients. Preferences for such an approach to clients' portfolios are consistent with the theory that large audit firms avoid risk because they suffer more than smaller firms in case of audit failure, taking into account damaged reputation and litigation concerns [11, p. 667]. Some research studies found evidence that support this theory. In Australia, Xu et al. revealed systematic differences with regard to the

issuance of MAOs, with the Big Four auditors issuing a significantly lower percentage of MAOs relative to non-Big Four auditors, which is related to their clients being, on average, larger and less risky [18, p. 27]. Also, in the Serbian regulated market the Big 4 are mostly oriented toward large companies. Moreover, since a number of listed companies had poor performance, it could be argued that this contributes to a lower market share of the Big 4. Due to avoiding risk, they tend to get engagements with companies characterized by better performance.

In order to understand client-specific financial reporting issues that lead auditors to modify their opinions, we conducted content analysis of audit reports with MAOs.

Financial reporting issues giving rise to MAOs

According to their professional standards, auditors must follow the prescribed form and content of auditor's report. When auditors express a modified opinion, they have to explain the underlying reason(s) for modification in a separate paragraph named Basis for Opinion. Thanks to these explanations we were able to reveal the background of MAOs in the Serbian regulated market. Figure 6 outlines the troublesome issues in financial reporting of regulated companies for the analyzed 2015-2017 period.

Our analysis has revealed that in 34 audit reports with modified opinion issued for 2015-2017, the total number of reasons for modification was 100, since in most cases companies that received MAOs actually had multiple failures in their financial statements. The average number of the matters giving rise to the modification is 2.9 per auditor's report with MAO.

Since public companies in Serbia prepare their financial statements in accordance with the International Financial Reporting Standards (IFRS), auditors use the recognition, measurement, presentation, classification and disclosure principles prescribed by this set of standards as relevant criteria for evaluating the truthfulness and fairness of the view presented in companies' financial statements. When explaining the modification, it is expected that auditors explicitly specify the standard violated by the client, which led to a misstatement in its financial statement or, in case of the limitation of audit scope, the standard which was

not supported by audit evidence. As presented in Figure 1, the highest percentage of reasons for MAOs (37%) is related to impairment of assets, revealing violation of requirements of IAS 2, IAS 36 and IAS 39. The majority of clients did not show willingness to calculate recoverable amounts of their assets, although there were strong indications of their impairment. Unfortunately, this finding suggests that regulated companies tend to overstate their assets and avoid timely recognition of impairment loss. Further analysis shows that many of these impairment cases (27%) are connected with inappropriate accounting policies related to allowances for uncollectible accounts receivables. The second place concerning overstatements is occupied by inventory account (22%), since companies ignored inventory obsolescence and needed a write-down of inventories to their net realizable value. Equal percentage of cases (16%) was caused by impairment of property, plant and equipment (PPE) and by intangibles. The remaining issues were related to impairment of other assets (e.g. investment in subsidiaries, short-term and long-term financial assets).

According to IFRS, a number of disclosures are required in financial statements in order to ensure their transparency. It is then possible that a material misstatement of financial statements could stem from an omission or inadequate disclosure. As it can be seen from Figure 1, issues related to disclosures accounted for 16% of reasons for MAOs in the observed sample. The majority of them (44%) concerned a disclosure of material uncertainty connected with the going concern. Around 19% of all issues were violations of disclosure requirements of IAS 37, dealing with provisions and contingent liabilities. Other noncompliance with disclosure requirements was related to many different standards (e.g. IFRS 7, IFRS 13, IAS 16).

The inability of auditors to obtain sufficient and appropriate audit evidence represents 14% of reasons for MAOs. Such inability was mainly caused by the circumstances where auditor was unable to observe the counting of physical inventories, to confirm receivables or liabilities due to the lack of responses to confirmation requests, to obtain evidence related to opening balances, or owing to inappropriate accounting records of clients. However, these limitations of the scope of the audit were

not so severe to trigger disclaimer of opinions, but rather qualified opinions.

PPE-related issues, other than impairment, led to MAOs mainly because of misapplication of selected accounting policies. More than a half of misstatements resulted from the misapplication of revaluation model for subsequent measurement of PPE. The main problem was that companies did not carry out revaluations regularly, which caused the carrying amount of PPE to materially differ from its fair value. Additionally, in some cases revaluation was not reasonable. There were also a few reasons for modification related to the application of the cost model, including depreciation policy and unreasonable estimation of residual value. Other cases include different issues (e.g. misclassification of assets), but it is interesting that in one case company disclosed the use of the cost model, although it actually implemented the revaluation model.

Our content analysis shows that auditors also find misstatements in assertions regarding liabilities and provisions, which accounted for 11% of all reasons for modifications. In most cases (73%), managers disagreed with auditors in recognizing provisions in accordance with the requirements of IAS 37 and IAS 19, specifically provisions related to litigations and termination benefits. Additionally, classification of liabilities into current and non-current is not fairly presented in some cases, since IAS 1 requires that the company treats as current liabilities all non-current liabilities that have become payable on creditors' demand because the company has breached covenants under a long-term agreement. Misstatement leading to the understatement of liabilities appeared only in one case.

Other reasons for MAOs include inappropriate use of the going concern assumption due to assessed inability of the client to continue its operations in the foreseeable future, misstatements related to the recognition of revenues and some other matters that appeared only once, namely improper measurement of non-current assets held for sale, ignoring adjusting events after the reporting period and misstatement related to deferred tax assets and liabilities.

To summarize, we find that most reasons for MAOs lie in the fact that financial statements contained material misstatements rather than in limitation of the scope of the

audit. According to the results presented here, material misstatements in financial statements mainly arose as a result of the choice of inappropriate or misapplication of selected accounting policies, while in a lower percentage they were caused by the lack of disclosures or inadequate disclosures. Interestingly, revenues were misstated only in few cases, although it is commonly held and empirically confirmed that revenues are a prominent area of manipulation in developed countries. On the other hand, PPE came to the fore as the most troublesome single item. It should also be noted that our findings reflect economic reality in Serbia, which is why it is not surprising that impairment of assets is the biggest problem since companies are faced with serious difficulties regarding collection of their receivables, obsolete inventories and insufficiently used PPE. Companies were obviously trying to artificially present a more favorable picture of their financial position through overstatement of assets and understatement of liabilities, at the same time avoiding income decline through non-recognition of impairment losses and other expenses. Auditors did not, however, make a quantification of the financial effects of misstatements in most of the cases, thus reducing the usefulness of the audit report for users who were not in the position to realize the extent of misstatements and adjust financial statements to their needs accordingly.

Matters emphasized by auditors

If auditors consider some matters that have already been adequately disclosed in financial statements important for the users' understanding of financial statements, they can draw their attention to these matters in the audit report by using the emphasis of matter (EoM) paragraph. This paragraph does not present the modification of the audit opinion or a substitute for modification. It is, nevertheless, important since it gives auditors the possibility to broaden

their communication with users to include relevant matters. Although for a long time investors and other users of financial statements and audit report were unsatisfied with the content of the audit report, demanding much more information from auditors, it was evident according to the International Auditing and Assurance Standards Board that, except for the circumstances for which emphasis of matter was explicitly required by the relevant standard (International Standard on Auditing 706 - ISA 706), auditors rarely used this paragraph in practice [9, p. 22].

We examined the frequency of use of EoM paragraph in audit reports on the regulated market in Serbia, as well as the nature of matters that are emphasized. Table 6 presents our findings about the inclusion of EoM paragraph in auditor's reports.

We concluded that the use of EoM paragraph by auditors in Serbia could not be described as rare, but quite the opposite. For the 2015-2017 period, about 41% of all audit reports contained an EoM paragraph, although this rate has slightly declined throughout the period. When comparing the frequency of the use of EoM paragraph in reports with modified and unmodified opinions, we found that auditors included this paragraph more frequently in reports with MAOs, even at the level of 80% in 2017. This result could indicate the propensity of auditors to exercise more caution with clients with lower quality of financial statements, thus warning users on multiple issues and risks that appeared with regard to these clients. Nevertheless, the ratio of EoM paragraph in reports with unmodified opinions could not be considered low. However, a downward trend is evident in this ratio, mainly as a consequence of delisting of companies which had an unmodified audit opinion with EoM paragraph.

An in-depth analysis of EoM paragraphs illuminates the nature of matters that were emphasized by auditors. Although a number of different issues appeared, the going concern issue was the most prominent item in EoM

Table 6: Frequency of EoM paragraph in audit reports on the regulated market in 2015-2017

	2015			2016			2017		
	Total	EoM	% EoM	Total	EoM	% EoM	Total	EoM	% EoM
Unmodified opinions	38	14	36.8	19	5	26.3	21	4	19.0
Modified opinions	10	7	70.0	14	8	57.1	10	8	80.0
Total	48	21	43.8	33	13	39.4	31	12	38.7

paragraphs coupled with MAOs. According to the Conceptual Framework of IFRS, these standards are appropriate for preparing financial statements if the reporting entity is able to continue its operation in the foreseeable future, which is why the going concern assumption is satisfied. If there is, however, material uncertainty related to the going concern assumption, although this assumption is still considered appropriate, the reporting entity must disclose this uncertainty. If disclosure is adequate, the auditor expresses unmodified opinion, but due to the importance of this matter for users of financial statements, the auditor is required to communicate it to the users. EoM paragraph was used for this purpose, but the latest changes in the model of audit report introduced a separate paragraph devoted to emphasizing material uncertainties related to the going concern. Therefore, this matter is not part of the EoM paragraph anymore. In Serbia, however, failure to timely translate ISAs results in a delay in their application, which is why for the whole analyzed period EoM paragraph included pointing out to material uncertainties related to the going concern if they existed.

Over the three-year study period, out of 23 MAOs with EoM paragraph in total, as much as 48% drew attention to disclosure about material uncertainties in relation to GC (going concern). The percentage of unmodified opinions with EoM for GC is 13%. In order to present the complete picture of GC issue in financial statements of regulated companies, we summarized all cases where GC was relevant, leading to EoM or modification. Table 7 shows GC-related figures.

For the 2015-2017 period, the average rate of GC-related audit reports in all issued reports was 21.4%, which indicates that more than one fifth of companies were faced with uncertainties to continue as a going concern. The highest rate was in 2016 when about 27% companies received GC-related reports. Auditors often specified several

reasons indicating GC problems, such as operation with loss, current liabilities above current assets, heavy debts and violation of loan covenants, followed by difficulties of raising additional capital for meeting related liabilities. It is also evident that, owing to the financial crisis, even developed countries experienced an increasing rate of GC-related reports, although these reports were mainly unmodified with EoM for GC. Carson et al. revealed that in Australia over the 2008–2010 period, the ratio of unmodified opinions with EoM on GC increased to around 19%, corresponding to the occurrence of the global financial crisis. However, the increasing trend regarding this ratio continued in the 2011–2013 period and reached 31% in 2013. Nevertheless, modifications on GC were still very rare [3, p. 233].

Auditors should consider whether GC assumption is appropriate and whether material uncertainties related to GC exist and are adequately disclosed. If GC assumption is not appropriate for the client who used it in their financial statements, the auditor must issue adverse opinion. When GC assumption is appropriate, but disclosures by the client are inadequate, the auditor shall also modify their opinion as qualified or adverse. EoM on GC is a case when disclosures are adequate. As presented in Table 7, auditors in Serbia generally issued EoM more often than modification in relation to GC. However, in our observed sample, all adverse opinions, as the most serious part of MAOs, were based solely or mainly on the GC issue.

Besides the GC issue, auditors found some other matters sufficiently important to be emphasized in the EoM paragraph. Those were assets pledged as security for liabilities, as well as uncertainties about the future outcome of litigations, tax effects of related parties' transactions and non-compliance with laws and regulations. According to ISA 706, there are additional issues that could lead to EoMs, but they are rarely observed in our sample in the study period (e.g. significant subsequent events). Content analysis, however, revealed that in some cases identification of matters emphasized, as well as their description, was not adequate. It seems that EoM is sometimes misused instead of modification. On the other hand, EoM paragraph is quite overburdened with issues which are not fundamental for users' understanding of financial statements. Furthermore,

Table 7: Proportion of GC-related audit reports in 2015-2017

	2015	2016	2017
Unmodified opinions with EoM on GC	4.2	3.0	0
MAOs with EoM on GC	6.3	15.2	9.7
MAOs with modification on GC	8.3	9.1	9.7

the description of matters is often excessive, since these matters should already have been disclosed in financial statements and the main purpose of EoM is only to direct users to these disclosures and prevent them from overlooking important information.

Conclusion

Audit reports present valuable information support to users of financial statements by disclosing independent audit opinion on fair presentation of financial statements. In case of audit reports with MAOs, auditors clearly warn users of financial statements of the area of financial reporting that contains or could contain material and even pervasive misstatements. It is, however, of great concern if a large number of companies in a country receive MAOs, especially if some PIEs are among them. In Serbia, in the 2015-2017 period the proportion of companies included in the regulated market on the Belgrade Stock Exchange that received MAOs was 30.4% on average. This result indicates serious problems in the whole system of financial reporting. Inappropriate normative and regulative framework, including weak monitoring and enforcement activities, has resulted in the lack of discipline in the process of financial reporting.

As our study reveals, the majority of modifications were related to misstatements in financial statements, reflected in overstatements of assets and understatements of liabilities, which generally led to a false presentation of the entity's financial position, as well as earnings. Such a situation makes it difficult for the users of financial statements to make investment decisions using information from the financial statements and has far-reaching negative consequences for the functioning of capital market. What is more striking, the average number of observed misstatements per audit report with MAOs is 2.9 and out of the companies that received MAOs, 77% received it more than once. This is the reflection of the lack of incentives for the correction of financial statements. It seems that, besides the weak regulatory environment, market forces also do not produce sufficient pressure in terms of financial constraints on companies with MAOs. The explanation could be the still undeveloped capital market in Serbia,

insufficient use of audit reports by banks and soft budget constraints related to state-owned enterprises. Only with extensive changes in the business climate and improvement of financial reporting quality may it be possible to cause a decrease in the ratio of companies that receive MAOs. In the meantime, MAOs enable insights into material deviations from the financial reporting framework, directing interested parties toward problematic areas of financial statements of reporting entities. It is also important to stress that the quality of auditing in Serbia has not yet reached a satisfactory level, which is why enhancement of audit quality could contribute to identifying even more issues in financial statements.

References

1. Barać, Ž., Vuko, T., & Šodan, S. (2017). What can auditors tell us about accounting manipulations?. *Managerial Auditing Journal*, 32(8), 788-809.
2. Carcello, J. (2012). What do investors want from the standard audit report?. *The CPA Journal*, 22-28.
3. Carson, E., Fargher, N., & Zhang, Y. (2016). Trends in auditor reporting in Australia: A synthesis and opportunities for research. *Australian Accounting Review*, No. 78, 26(3), 226-242.
4. Chen, S., Su, X., & Wang, Z. (2005). An analysis of auditing environment and modified audit opinions in China: Underlying reasons and lessons. *International Journal of Auditing*, 9, 165-185.
5. European Commission. (2017). *Report from the Commission to the Council, the European Central Bank, the European Systemic Risk Board and the European Parliament on monitoring developments in the EU market for providing statutory audit services to public-interest entities pursuant to Article 27 of Regulation (EU) 537/2014*.
6. European Union. (2014). *Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts*. Brussels: European Union.
7. Gassen, J., & Skaife, H. (2009). Can audit reforms affect the information role of audits? Evidence from the German market. *Contemporary Accounting Research*, 26(3), 867-898.
8. Habib, A. (2013). A meta-analysis of the determinants of modified audit opinion decisions. *Managerial Auditing Journal*, 28(3), 184-216.
9. International Auditing and Assurance Standards Board. (2012). *Invitation to Comment - Improving the Auditor's Report*.
10. International Ethics Standards Board for Accountants. (2018). *Handbook of the International Code of Ethics for Professional Accountants including International Independence Standards*. International Federation of Accountants, New York.
11. Johnstone, K., & Bedard, J. (2004). Audit firm portfolio management decisions. *Journal of Accounting Research*, 42(4), 659-690.

12. *Law on the Capital Market*. (2016). Official Gazette of RS, No 31/2011, 112/2015 and 108/2016.
13. Lennox, C. (2000). Do companies successfully engage in opinion-shopping? Evidence from the UK. *Journal of Accounting and Economics*, 29, 321-337.
14. Le Vourch, J., & Morand, P. (2011). *Study on the effects of the implementation of the acquis on statutory audits of annual and consolidated accounts including the consequences on the audit market*. Paris: ESCP Europe.
15. Lin, S., Jiang, Y., & Xu, Y. (2011). Do modified audit opinions have economic consequences? Empirical evidence based on financial constraints. *China Journal of Accounting Research*, 4(3), 135-154.
16. SEC Staff Accounting Bulletin. (2011). Topic 1E – Requirements for audited or certified financial statements. In *Codification of staff accounting bulletins, Topic 1: Financial statements*. Retrieved from <https://www.sec.gov/interps/account/sabcodet1.htm#E>.
17. Stager, V., & Odar, M. (2017). Audit fees for the segments of non-listed auditees in Slovenia. *Journal of Global Economics*, 5(3), 1-8.
18. Xu, Y., Jiang, L., Fargher, N., & Carson, E. (2011). Audit reports in Australia during the Global Financial Crisis. *Australian Accounting Review*, 21(1), 22-31.
19. World Bank. (2015). *Republic of Serbia - Report on the Observance of Standards and Codes (ROSC) on accounting and auditing: update (English)*. The World Bank Centre for Financial Reporting Reform.
20. World Bank. (2009). *People's Republic of China - Report on the Observance of Standards and Codes (ROSC) on accounting and auditing*. The World Bank Financial Management – Central Operational Services Unit East Asia and Pacific Region.



Savka Vučković Milutinović

is Assistant Professor at the Faculty of Economics, University of Belgrade. She is a member of the Department for Accounting and Business Finance and teaches courses in the field of auditing within undergraduate and master programs. As a lecturer, she has participated in many education courses related to the implementation of professional standards in Serbia. She co-authored a book on auditing and published articles in the area of auditing and financial reporting.