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# AUDIT REPORTS – IMPORTANT INSTRUMENT FOR ENHANCING THE TRUST IN ANNUAL FINANCIAL STATEMENTS

**Toma Donchev, PhD***

***Abstract:*** *The financial and economic crisis of 2008 shows a crisis of confidence in the independent financial audit. The EU held a public consultation through which to discuss the role, organization and execution of independent financial audit. As a result, changes in EU legislation have been initiated. One of changes is related to the expansion of the content and the number of audit reports. In the paper is presented the audit report on the financial statement and report for the Audit Committee. The author supports the statement that audit reports are important tools for communication between auditors and users of financial statements.*

***Key words:*** *statutory financial audit, audit report*

## Introduction

Independent financial audit is designed to minimize information risk for users of financial statements and express an opinion whether the financial statements are prepared in all material respects, in accordance with applicable financial reporting framework. Studies that analyze the causes and seeking solutions to overcome the global financial and economic crisis of 2008, indicated that the audit is not meeting expectations of users. This paper aims to present briefly the legal regulation of independent financial audit in the EU and some proposals for changes to re-establish trust and market confidence. We believe that the improvement and expansion of the audit reports, compared to existing unified audit reports would improve understanding and increase confidence in the financial statements.

## 1. Crisis in Independent Financial Audit

Publishing of reports that contain errors and inaccuracies can lead ultimately to bankruptcy, which means that a high price is paid from the owners, creditors, and broader society. Accordingly, the financial statements which give true and fair view of financial position of companies contributes to confidence and protection of investors, reduce the cost of capital for the company and contribute to the prosperity of society. Auditors are

* UNWE, Faculty of Finance and Accountancy, Department: Financial Control, Sofia, Bulgaria; e-mail: toma_donchev@yahoo.com
UDC 657.635

entrusted by society to give a professional opinion on the truth and fairness of the financial statements. With the advent of the crisis, some people wondered why after auditors certify that financial statements give true and fair view about financial position of companies and financial institutions, the latter after a short period of time faced bankruptcy. It can be assumed that parties interested in audits are not very familiar with the limitations of the audit (providing reasonable assurance, risk assessment, sampling approach, materiality, the auditor's responsibilities to detect fraud, etc.). However it is certain that there is a gap between expectations of users of financial statements, respectively, the audit opinion and what actually auditors provide.

Furthermore, there are potential threats related to insufficient independence of statutory auditors, mainly due to provision of additional services and high barriers to entry in the audit market, which led to an oligopoly of the Big 4. Due to various national practices in EU-countries, there are concerns for ineffective oversight of audit work. Because of miscellaneous national legislation, is considered, that there are problems with cross-border application of audit profession, application of different auditing standards and excessive burden on small and medium enterprises in connection with the audit.

After determining these problems the European Commission launched a broad debate on the topic by Green paper "Audit Policy: Lessons from the Crisis". It was made impact assessment of various potential measures for change (European Commission, Impact assessment, 2011). As a result, EC proposed to amend Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and to adopt an entirely new Regulation on specific requirements regarding statutory audits of public-interest entities. The **main objectives of the reform** are to (European Commission, Reform of the Audit Market, 2011):

- clarify and define more precisely the role of the auditor;
- reinforce the independence and professional scepticism of the auditor;
- make the top end of the audit market more dynamic;
- improve the supervision of auditors;
- facilitate the cross-border provision of statutory audit services; and
- reduce unnecessary burdens for SMEs.

**Specific changes** that are proposed to be introduced are (European Commission, Reform of the Audit Market, 2011):

- Mandatory rotation of the audit firm after 6 years (9 years if two audit firms used). A cooling off period of 4 years will be applicable.
- Prohibition of Big 4-only contractual clauses (clauses requiring that the audit is undertaken by one of the Big 4 firms).
- Mandatory tendering for audit mandates.
- Stricter rules on the appointment of auditors with an increased role for the audit committee.
- The audit committee's recommendation for the appointment of an auditor should be discussed at the general meeting of shareholders. The audit committee's independence and technical competence should be reinforced: at least two of its members must be independent and at least one should have knowledge of audit.

- Auditors will be prohibited from providing non-audit services to audit clients. The provision of non-audit services to non-audit clients is allowed.
- Large audit firms will be required to separate their audit activities into pure audit firms i.e. a complete ban on the provision of non-audit services by the large audit firms.
- EU-level cooperation by the European Securities and Markets Authority (ESMA).
- National audit supervisory authorities would be strengthened. The mandate, powers and independence requirements for audit supervisors would be established at EU level, but supervision would be carried out nationally.
- European certification of audit firms recognising their aptitude to perform high quality audits of listed companies. The certificates would be issued by ESMA.
- Regular dialogue will be held between auditors, audit committees and supervisors.
- Mutual recognition of statutory auditors approved in Member States to ensure cross-border mobility of auditors.
- The content of the audit report will be expanded to provide more information to all stakeholders.
- An additional more detailed audit report for the audit entity itself which will provide detailed information on the audit carried out to the audit committee and management.
- Establishing additional requirements on the internal organisation and governance of audit firms.
- Compliance with the International Standards on Auditing (ISAs) by all statutory auditors and audit firms. Member States should ensure that the audit standards are adapted to the size of the audited entity to ensure a proportionate and simplified audit for SMEs.

## 2. Expanded Audit Report

From the whole package provided by the EC, this paper will examine changes in audit reports issued by the auditor. Proposal stipulate that the auditor shall prepare audit report which contains an audit opinion, transparency report of the auditor, additional report to the Audit Committee and report to supervisors of public-interest enterprises.

At the moment, **audit report content is regulated by ISA**. Uniformed from the standards report should contain (IFAC, 2012 Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements, 661-664):

- Title that clearly indicates that it is the report of an independent auditor;
- Addresse;
- Entity whose financial statements have been audited;
- State that the financial statements have been audited;
- Title of each statement that comprises the financial statements;
- Summary of significant accounting policies and other explanatory information;
- Date or period covered by each financial statement comprising the financial statements;
- Management’s Responsibility for the Financial Statements;

- Auditor's Responsibility;
- Auditor's Opinion;
- Other Reporting Responsibilities;
- Date, Address, Signature of the Auditor.

In proposal for Regulation on specific requirements regarding statutory audits of public-interest entities is determined to be added **more information in audit report**. Based on its characteristics, this information can be differentiated in several groups.

First group is related to the terms of the audit engagement. It is expected the report to include information which authority has chosen the statutory auditor. This is important for revealing the role of the Audit Committee in the selection and also to make clear the responsibilities of operational management for appointing the auditor. It should be pointed out and the whole period of continuous engagement, including prior renewals prior and reappointments, which will allow verifying compliance with the limit number of mandates of the auditor. The public-interest entity shall appoint a statutory auditor or audit firm for an initial engagement that shall not be shorter than two years. The public-interest entity may renew this engagement only once. The maximum duration of the combined two engagements shall not exceed 6 years. Where throughout a continuous engagement of 6 years two statutory auditors or audit firms have been appointed, the maximum duration of the engagement of each statutory auditor or audit firm shall not exceed 9 years. After the expiry of the maximum duration of the engagement, the statutory auditor or audit firm, shall not undertake the statutory audit of the public-interest entity concerned until a period of at least four years has elapsed.

The second group includes information on the nature and manner of performing the audit engagement. The study done by the Commission shows that this is critical information for users of the audit report. There is a misunderstanding of the nature of audit work, methods and approaches for collecting and processing information. So the report should contain a description of the methodology, including which part of the balance sheet has been directly tested and what is checked based on internal control system evaluation. Some stakeholders believe that the audit should go back to their roots and leave the system risk-based approach and carry out checks on all information being used for the preparation of financial statements. We believe that this is somewhat justified when it comes to small businesses audited. But it is not acceptable as a whole because it is not certain that it will lead to higher quality or a different audit opinion. Higher cost of full examination is an issue, too. Auditor is expected to explain any variation in the weighting of substantive and compliance testing when compared to the previous year, even if the previous year's statutory audit had been conducted by another statutory auditor. Probably in relation with pressure from users for greater skepticism is laid down the requirement auditor to provide detailed information on the level of materiality applied in the statutory audit. Again, due to public misunderstanding, in the report must be explained the extent to which the statutory audit was planned to detect irregularities, including fraud.

The third group contains requirements related to audit findings. The auditor should report main areas of risk for material misstatement in annual and consolidated financial statements, including significant accounting estimates and areas of measurement uncertainty. It should be pointed out and explained each violation of accounting rules or breach of legislation or articles ofincorporation, decisions regarding accounting policies and other issues that are relevant to management. It is kept the requirement the auditor to evaluate internal control. These requirements are not entirely new, but are now stricter and their scope is extended. The author of this paper agrees that the weaknesses of internal control system and in the implementation of external and internal regulations must be reported by the auditor, but this must be balanced, carefully considered in light of the materiality and should not result in too critical attitude to the audited entity. Listing many weaknesses do not necessarily mean that overall control and management of the company are weak.

Perhaps this is the place to present another issue discussed during the debate. Beside from auditing firms participating in the discussion, a large part of the other participants are not satisfied with the auditor's opinion in the reports and the language used there. It is believed that unqualified opinion is considered as "mandatory" and only in very extreme cases it is modified. This does not correspond the actual state of the financial statements, secondly, does not allow distinguishing between statements with different quality. With the including additional information in the audit report, auditors can be assured that giving modified opinion, it will not be understood as "bad", but reasonable appraisal of audited financial statements. Users of the audit report would also like the simplification of expression in the audit report.

The fourth group requires the auditor to evaluate the ability of the entity or the group to perform their duties in the near future and to continue working as a going concern. This is one of the key and controversial issues related to the role of the auditor. Auditor is tempting to "ensure" to the users of the audit report that audited company will continue to operate for the foreseeable future, but in practice it is impossible. The auditor can provide reasonable assurance judging the risks to the company and the policies that company applies. Some professionals do not agree that auditors should provide strong guarantees for financial health of the companies as credit rating agencies do. But at the same time we should not deny the possibility auditing of financial statements to develop into a diagnostic and prognostic audit (Dinev, M., Yearbook ICPA-Bulgaria 2007, 12-13). However this can be topic of another paper.

The fifth group is related to auditor independence, particularly with the additional services rendered. It will be required from auditor to declare that it has not provided unauthorized services other than audit, and that during audit process the statutory auditor or audit firm retained its full independence. When the statutory audit is conducted by an audit firm, the report indicates each member participating in the audit engagement, and declares that all members are kept fully independent and have no direct or indirect interest in the audited entity. A statutory auditor may provide related financial audit services, which are (a) the audit or review of interim financial statements; (b) providing assurance on corporate governance statements; (c) providing assurance on corporate social responsibility matters; (d) providing assurance on or attestation of regulatory reporting to regulators of financial institutions beyond the scope of the statutory audit and designed to assist regulators in fulfilling their role, such as on capital requirements or specific solvency rations determining how likely an undertaking will be to continue meeting its debt obligations; (e) providing certification on compliance with tax requirements where such attestation is required by national law; (f) any other statutory duty related to audit work imposed by Union legislation to the statutory auditor or audit firm.

A statutory auditor shall not directly or indirectly provide (i) expert services unrelated to the audit, tax consultancy, general management and other advisory services; (ii) bookkeeping and preparing accounting records and financial statements; (iii) designing and implementing internal control or risk management procedure related to the preparation and/or control of financing information included in the financial statements and advice on risk; (iv) valuation services, providing fairness opinions or contribution-in-kind reports; (v) actuarial and legal services, including the resolution of litigation; (vi) designing and implementing financial information technology systems for public-interest entities as referred to in Article 2(13)(b) to (j) of Directive 2006/43/EC; (vii) participating in the audit client's internal audit and the provision of services related to the internal audit function; (viii) broker or dealer, investment adviser, or investment banking services.

Audit report must identify services other than auditing for which the statutory auditor or audit firm are authorized by the audit committee or the public oversight body to render them to audited entity. Designing and implementing financial information technology systems for public-interest entities as referred to in Article 2(13)(a) of Directive 2006/43/EC and due diligence services to the vendor or the buy side on potential mergers and acquisitions and providing assurance on the audited entity to other parties at a financial or corporate transaction can be provided after prior approval of audit oversight body. Human resources services, including recruiting senior management and providing comfort letters for investors in the context of the issuance of an undertaking's securities can be provided after prior approval of Audit Committee

The last but not the least group, explicitly requires the auditor to express an opinion on compliance and other characteristics of the annual activity report with annual financial statements for that financial year. This requirement, although is already applied legitimizes the extension of financial audit to confirm the non-financial information! Publication of additional non-financial information from the companies (European Commission, Non-Financial Reporting, 2011), its verification from statutory auditor are issues which will probably evolve and may be subject of separate research.

When more than one statutory auditor or audit firm have been appointed to carry out the statutory audit of the public-interest entity, they shall agree on the results of the statutory audit and submit a joint report and opinion. In case of disagreement, each statutory auditor or audit firm shall submit his, her or its opinion separately. If one statutory auditor or audit firm qualifies his, her or its opinion, submits an adverse opinion or a disclaimer of opinion, the overall opinion shall be considered as qualified, adverse opinion or a disclaimer of opinion. In a separate paragraph each statutory auditor or audit firm shall state the reasons of disagreement.

We believe that the proposed regulation contains reckless requirement, namely that audit report should not be longer than four pages or 10,000 characters. The most likely reason for this is not to distract users of the report with endless data and report to remain concise and comprehensible. But we do not believe that this volume of report is sufficient and should be increased.

The discussion could not find a satisfactory answer whether the audit report is submitted on time and are any improvements possible. There is a need to shorten the time between the end of financial year and publication of the audit report, but the majority of respondents think that reducing the time available for the auditor to gather and analyse audit evidence would present a risk to audit quality.

Author of the paper believes that expanding content of the general audit report should be recommended not only for businesses in the public interest, but for all businesses subject to statutory audit within the meaning of Directive 2006/43/EC. The arguments in favor of this proposal are the advantages result of additional information which was mentioned above. Perhaps the only argument against, could be additional costs that will burden the audited entities. But in impact assessment is indicated that additional information will take an average of 8 hours for big companies of public interest and probably less for smaller companies (European Commission, Impact assessment, 2011, 243).

## 3. Additional Report to the Audit Committee

The statutory auditor carrying out statutory audit of public-interest entities shall submit an additional report to the audit committee of the audited entity. If the audited entity does not have an audit committee, the additional report shall be submitted to the body performing equivalent functions within the audited entity. The audit committee or the body performing equivalent functions is allowed to transmit the additional report to the management, administrative or supervisory body of the audited entity. The additional report shall be disclosed to the general meeting of the audited entity if the management or administrative body of the audited entity so decides. It explains in detail and explicit results of the statutory audit and:

- indicate and explain judgments about material uncertainty that may cast doubt about the entity's ability to continue as a going concern;
- determine in detail whether the bookkeeping, the accounting, all audited documents, the annual or consolidated financial statements and possible additional reports show appropriateness;
- indicate and explain in detail all instances of non-compliance, including nonmaterial instances as far as it is considered to be important to the audit committee in order to fulfil its tasks;
- assess the valuation methods applied to the various items in the annual or
- consolidated financial statements including any impact of changes of such;
- provide full details of all guarantees, comfort letters, undertakings of public intervention and other support measures that have been relied upon when making a going concern assessment;
- confirm the attendance at stock takes as well as other instances of physical verification, in case such stock takes or verifications took place;
- indicate and explain the principles of consolidation in the case of a statutory audit of consolidated financial statements;
- indicate which audit work is performed by third-country auditor, statutory auditor, third-country audit entity or audit firm in case of a statutory audit of consolidated financial statements;
- indicate whether all requested explanations and documents were provided by the audited entity.

Undoubtedly, the audit committee plays an important role - to monitor and assist financial reporting, creation and functioning of internal control system, the implementation of the internal audit function, the performance of independent financial audit and coordination between all these activities. Without adequate communication with the statutory auditor, these tasks could not be completed effectively. We fully support the preparation of such audit report.

Unlike the general audit report, the author agrees that a report to the Audit Committee should be prepared only public-interest entities. There are several arguments for this. Companies that are not in the public interest would have smaller volume of activities, less complex organization, which means that it is likely for auditor to have effective communication with operational management and to raise important issues before them. And also only public-interest entities are obliged to establish an audit committee.

## 4. Other Reports

In the regulation is added obligation of the auditor carrying out the statutory audit of a public-interest entity shall have a duty to report promptly to the competent authorities supervising public-interest entities any fact or decision concerning that public-interest entity of which he, she or it has become aware while carrying out that statutory audit and which is liable to bring a material breach of the laws, regulations or administrative provisions which lay down, where appropriate, the conditions governing authorisation or which specifically govern pursuit of the activities of such public-interest entity or the impairment of the continuous functioning of the public-interest entity or a refusal to certify the financial statements or the expression of reservations.

Finally, the statutory auditor or audit firm carrying out statutory audits of companies in the public interest, should publish an annual transparency report no later than three months after the end of each financial year. Annual transparency report published on the website of the statutory auditor shall remain available there for at least five years.

We do not pay special attention to these two reports, because they do not constitute any changes in the audit reporting process. The transparency report is an obligation that existed so far. Reporting to supervisor bodies simply documents information flow, which is ongoing at the moment. Similar information has been obtained by supervisors from audit report and from communication, part of their standard duties. Subject of a separate study could be interaction between statutory auditor and supervisor bodies – is it a good idea to report only information that would lead to "serious" violation, how frequent the information should be exchanged, etc.

## Conclusion

European Commission plays a leading role in overcoming global crisis. Combined efforts are exerted for improvements in various areas of life. For recovery of financial stability, beside measures related to the audit, are carried out improvements in financial sector supervision, the role of central banks and corporate governance. Robust audit is key to rebuilding trust and confidence in the markets. It will provide investors with easily accessible, reliable and cost-effective information on the financial statements of companies. It will reduce the cost of capital for audited companies by providing transparent information about their financial situation, and also lower costs of financial institutions, providing analysis of financial condition prior to the granting of funds. Audit reports are a powerful tool for communicating audit work. Including information about methodology of audit, risks and threats which the company is facing, the auditor's performance and its relationships with customers will strengthen the relationship between users of financial information from financial statements and companies subject to audit.

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## REVIZORSKI IZVEŠTAJI – ZNAČAJAN INSTRUMENT ZA POVEĆANJE POVERENJA U GODIŠNJIM FINANSIJSKIM IZVEŠTAJIMA

**Rezime:** Finansijska i ekonomska kriza od 2008. pokazuje krizu poverenja u nezavisne finansijske revizije. EU je održao javnu raspravu da bi razgovarao o ulozi, organizaciji i sprovođenju nezavisne finansijske revizije. Kao rezultat toga, pokrenute su promene u zakonodavstvu EU. Jedna od promena se odnosi na proširenje sadržaja i broj revizorskih izveštaja. U dokumentu je predstavljen revizorski izveštaj o finansijskom izveštaju i izveštaj Odbora za reviziju. Autor podržava izjavu da su revizorski izveštaji važna sredstva za komunikaciju izmedju revizora i korisnika finansijskih izveštaja.

**Ključne reči**: statutarna finansijska revizija, revizorski izveštaj