
Aspects Regarding the Changes to the Independent Auditor's Report. The Case of Public Interest Entities

Denis Adrian LEVANTI,
Manager, Assurance Department, PwC Romania,
e-mail: levantidenis@yahoo.com

Abstract

The time when the auditors of the public interest entities have been issuing a standardized audit report, without describing the most significant risk identified throughout the audit process, has ended. In the new reporting framework, the audit reports provide more information and transparency to stakeholders, in particular on the significant matters discussed by the auditors with those charged with the entities' governance.

The purpose of the research is to identify and analyze the key audit matters reported by the financial auditors for a sample of public interest entities in Romania. The results highlighted that most auditors complied with ISA's requirements on the presentation of key audit matters, respectively that auditors have different approaches in terms of the average number of key audit matters reported, nature of the key audit matters and disclosure of the materiality used in the audit process.

Keywords: audit report, public interest entities, key audit matters, stakeholders

JEL Classification: M42

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To cite this article:

Levanti, D. A., (2019), Aspects Regarding the Changes to the Independent Auditor's Report. The Case of Public Interest Entities, *Audit Financiar*, vol. XVII, no. 3(155)/2019, pp. 486-495, DOI: 10.20869/AUDITF/2019/155/018

To link this article:

<http://dx.doi.org/10.20869/AUDITF/2019/155/018>
Received: 07.05.2019
Revised: 13.05.2019
Accepted: 29.06.2019

Introduction

In the aftermath of the global financial crisis and with growing complexity of financial reporting, investors' demands for more informative reporting have increased. The auditing profession had to respond to investors who expressed dissatisfaction over the audit report; a simple opinion, according to which the financial statements give a true and fair view on an entity's activity was no longer sufficient. Beyond the qualified or unqualified opinion, the audit report contained mostly standardized wording.

The investors' demands did not focus only on the audit reports containing an unqualified opinion but also on those that expressed a qualified one. In this context, the auditor's opinion needed to be supplemented with bespoke descriptions of key audit matters identified during the audit. The Financial Reporting Council in the United Kingdom responded first, introducing new requirements for the auditors of entities subject to the United Kingdom's Corporate Governance Code for periods commencing from 2012. The International Auditing and Assurance Standards Board (IAASB) later released its new auditor reporting standards effective for periods ending on or after 15 December 2016. Following the IAASB's action, the standard-setting bodies in several countries revised their national standards to ensure compliance with the internationally agreed rules.

The most important changes in the structure of the audit report include: the section on the auditor's opinion is now placed first, introduction of a new section dedicated to key audit matters description, disclosure of the management and auditor responsibility with regards to the going concern and of any uncertainties in this respect, the auditor's affirmative statements of independence and compliance with the Code of Ethics.

With regards to the auditing of public interest entities, at European Union (UE) level, the new auditors' reporting requirements were implemented by EU Regulation no. 537/2014 of the European Parliament and of the Council on specific requirements regarding the statutory audit of public interest entities.

In this context, this research aims to identify and analyze the key audit matters presented by the financial auditors in the audit reports issued in connection with the financial statements of the most important public interest entities from Romania, namely the entities listed on the Bucharest Stock Exchange (BSE) and credit institutions.

Compared to the results of the existing research on this topic, the contribution of this paper is that it identifies and analyses the key audit matters reported as at 31 December 2017 by the financial auditors of the most important public interest entities in Romania based on their nature, industry in which they operate, different approaches of the auditors in terms of the average key audit matters report and disclosure of materiality.

Moreover, we also believe that the study can be used as a benchmarking tool by stakeholders and other parties interested in the outcome of the audit process, including: financial auditors, management staff and investors.

The article has the following structure: the first section is dedicated to literature review on the audit report, followed by the section which describes the research methodology. The next section includes the results obtained with the paper, ending with the section dedicated to conclusions reached.

1. Literature review

The purpose of an independent expert's opinion is to strengthen the credibility of an entity's financial statements. The communication of the auditor's opinion is called attestation; in an audit, this attestation is called *audit report* (Hayes et al., 2015).

Land (2014) finds it surprising that the auditor report, the only independent voice on the financial statements prepared by an entity, is the only part of a set of financial statements in which there is no reading point. The author also notes that the audit report has not undergone fundamental changes for 80 years in the United States of America and approximately 150 in the United Kingdom.

The primary users of the financial statements of a public interest or private entity are its shareholders and investors, followed by other stakeholders. Abma (2009) indicates that the Corporate Governance Forum Eumedion, one of the institutions representing the interests of European investors, has sent a letter to the International Organization for Securities (IOSCO), expressing its views on the informative value of the audit report. The Forum's proposal was to reorganize the audit report so that it becomes an important form of communication between auditors and investors. An example indicated by the Forum was the inclusion in the audit report of the professional judgments undertaken by the auditor during the audit process.

Also, Asare and Wright (2012) believe that the traditional reporting model is highly standardized and therefore perceived as insufficiently useful, informative and transparent. In particular, in the aftermath of the financial crisis of 2008, regulators, standard-setters and the investment community started seriously questioning the informative value of the auditor's report. Similarly, academic research in the last decade has also repeatedly emphasized that there may be a need for change, motivating audit report reforms. For example, Carcello (2012) and Turner et al. (2010) find that users generally valued the auditor's opinion but showed little interest in reading the actual report given its highly standardized format. The results of the study performed by Church et al. (2011) and Gray et al. (2011) showed that users assessed the traditional auditor's report as uninformative in particular because nearly all public companies receive the same unqualified opinion.

Following their study, Mock et al. (2013) concluded that stakeholders desire more information about the audit, the auditor and financial statements. Moreover, Vanstraelen et al. (2012) find that users were interested in additional disclosures on audit findings such as key areas of risks.

Given this context, IAASB revised the International Auditing Standards („ISA”) related to auditor reporting. The IAASB considers that the new standards ensure increased transparency and informative value of the audit report, respectively an improved communication between auditors and investors and an increase attention from the entities' management and those charged with governance with regards to the information presented in the financial statements, subject to the audit process and audit report issuance.

In relation to public interest entities, the most important changes to the auditor report is the presentation of the key audit matters. According to ISA 701 “Communication of key audit matters in the audit report” (ISA 701), paragraph 8, the key audit matters represent those matters which, in the auditor's professional opinion, were the most significant during the financial statements audit. The paper continues with the presentation of a series of opinions and results of studies undertaken on the impact of the publication of the extended audit report and disclosure of key audit matters on the stakeholders.

Cates (2014) observes that the new audit report is submitted and actively discussed among shareholders as part of the usual review of the entity's activity. Richards (2014) states that he was pleasantly surprised

by the usefulness of the new information presented in the report.

Banerjee (2017) welcomes the developments brought to the audit report, the introduction of the new elements removing the mystery of the auditors' work and the manner through which they based their opinion. For listed entities, Sim (2017) believes that the key audit matters are the basis for conversations between the Directors and institutional and retail investors.

Among the studies conducted on this topic, we mention the one conducted by Kohler et al. (2016), which aimed to examine the communicative value of the expanded auditor's report among institutional and retail investors. They find that investment professionals' assessments of the economic situation of a company are influenced by variations in the key audit matters disclosures, however, these appear to have no communicative value for retail investors as they have difficulties to process the new information presented.

The experimental study by Carver and Trinkle (2017) suggests that retail investors believe that the disclosure of the key audit matter lead to a less readable report that did not result in incremental changes of investors' valuation judgments. The study by Sirois et al. (2018) shows that the information on the key audit matters increases users' attention to key audit matters-related information in the financial statement disclosures.

Gutierrez et al. (2018) states that they did not identify any evidence to conclude that the additional information included in the audit report influences investors' reactions and decisions. This is aligned with the findings of Lennox et al. (2018), concluding that disclosure of the key audit matters does not influence investor behavior.

Overall, the studies conducted so far and interviews with industry professionals, provide mixed results regarding investor behavior and market reaction in response to key audit matters disclosure. From this perspective, we consider that further research is necessary to explore the economic consequences associated with key audit matters disclosure.

2. Research methodology

In order to achieve the research objective we used the qualitative research method.

The research premise has taken into account the public interest entity definition according to Law no. 162/2017 related to the statutory audit of annual financial statements and consolidated financial statements. The

definition public interest entity is broad, so for the analysis purpose, we included only those entities whose shares have been admitted for trading on BSE and credit institutions operating on the Romanian market.

To determine the sample, we considered the following:

- All 78 entities whose shares are tradable on BSE, sector Bucharest Stock Exchange, status “Tradeable”. For two of these we were unable to obtain the audit report from public sources and three of them are credit institutions, legal entities registered in Romania, that were included in the sample dedicated to this type of entities;
- Top 25 credit institutions operating on the Romanian banking market. For two of these we were unable to obtain the audit report from public sources and three of them are branches of foreign credit institutions whose financial statements are prepared by the parent entity.

Therefore, the sample comprises a total of 93 public interest entities, out of which 73 are entities whose shares are traded on BSE and 20 are credit institutions, legal entities registered in Romania, having a market share of 84.03% as at 31 December 2017 based on total assets value.

We reviewed the audit reports issued in connection with the statutory statements for financial periods ending as at 31 December 2017 because as at the time of our analysis the deadline for submission of the financial statements for the financial period ending 31 December 2018 was not exceeded. Please note that all entities

included in the sample prepared their financial statements in accordance with the International Financial Reporting Standards (IFRS). The audit reports were obtained from public sources, by investigating the information available on the BSE official website and those of the entities included in the sample.

To achieve the proposed goal, we completed the following steps:

- Sample establishment and identification of data sources;
- Obtaining the audit reports from public sources;
- Individual analysis of the audit reports and data collection with regards to: auditor name, report format, type of opinion issued, reported key audit matters, disclosure of materiality, non-audit services disclosures;
- Analysis of data collected; and
- Interpretation of results obtained.

3. Results and discussions

A first analysis revealed the distribution of the entities according to the industry in which they operate. The results showed that the 93 analyzed entities operate in 19 different industries. Regarding the entities listed on BSE, we note that the activity of 30% of them is concentrated around 3 industries, namely: production and processing (manufacturing), financial services (investment entities, insurance brokers) and construction (**Table no. 1**).

Table no. 1 Public interest entities included in the sample, by industry

Industry	No. of entities	% of total no. of entities
Banking	20	22%
Manufacturing	11	12%
Financial services	9	10%
Constructions	7	8%
Electro-technical and electronics	7	8%
Oil and gas	6	6%
Industrial goods	4	4%
Pharmaceutical	4	4%
Real estate	4	4%
Energy	3	3%
Food industry	3	3%
Automobiles	3	3%
Hotels	3	3%
Other	9	10%
TOTAL	93	100%

Source: Author's own analysis

The analysis continues with the identification of audit firms' distribution, separately for entities listed on BSE (Table no. 2) and credit institutions (Table no. 3). We observed that only 38% of the entities listed on BSE have their financial statements audited by a Big 4 company (PricewaterhouseCoopers – PwC, Deloitte, Ernst & Young – E&Y and KPMG), compared to the credit institutions,

whose financial statements are audited exclusively by these companies. This is justified by the stricter rules imposed by the National Bank of Romania through the regulations issued on the requirements related to the auditors' reputation and experience. 52% of the entities listed on BSE are audited by local audit firms or financial auditors, individuals.

Table no. 2 Financial auditors of entities listed on BSE

Audit firm	No. of audited entities	% of the total no. of audited entities
Other financial auditors	38	52%
Big 4	28	38%
BDO & Mazars	7	10%
TOTAL	73	100%

Source: Author's own analysis

Table no. 3 Financial auditors of credit institutions

Audit firm	No. of audited entities	% of the total no. of audited entities
PwC	6	30%
Deloitte	6	30%
KPMG	4	20%
E&Y	4	20%
TOTAL	20	100%

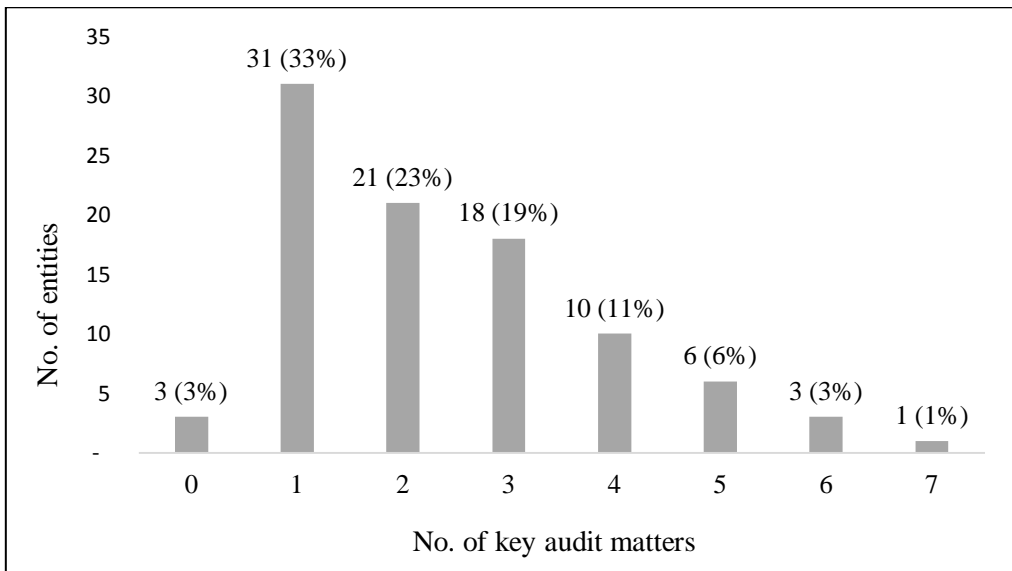
Source: Author's own analysis

Moving forward, we will identify and analyze the key audit matters presented in the audit reports. In order to establish the key audit matters, financial auditors take into account the following criteria: significant risk areas, accounting areas that require significant professional judgment of the auditor and the impact of the significant transactions on the audit. Out of the most significant matters identified, the auditor selects those that have a significant impact on the financial statements and reports them as key audit matters to those charge with governance. *Figure no. 1* shows the total number of key audit matters reported in the analyzed audit reports.

The results of the research revealed the following:

- 75% of the audit reports contain between 1-3 key audit matters, the most frequently encountered being the audit reports containing only one key audit matter;
- 22% of the reports include four to seven key audit matters; and
- For 3% of the reports, the auditor did not report any key audit matters (Electroaparataj SA, Electromagnetica SA and SNTGN Transgaz SA.), which does not comply with ISA 701 revised requirements.

Figure no. 1. Number of key audit matters per entity

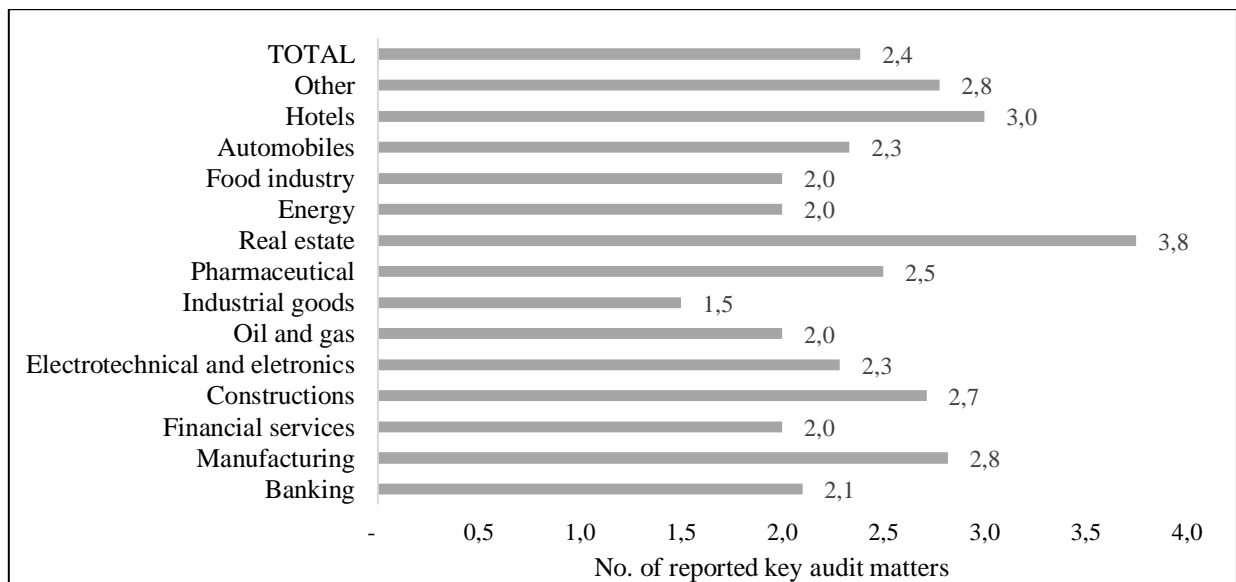


Source: Author's own analysis

From **Figure no. 2** we note that the auditors reported on average 2.4 key audit matters per report. The highest values were identified for entities operating in telecommunications, real estate and chemical industries. At the opposite pole are found those operating in the

medical, services and industrial goods industries. For credit institutions, the average number of key audit matters reported is below the average recorded at sample level, with the auditors reporting one of two audit matters for 70% of the analyzed institutions.

Figure no. 2. Average number of key audit matters reported per industry



Source: Author's own analysis

Figures no. 3 and 4 illustrate the reporting frequency of the key audit matters per industry, separately for entities listed on BSE and credit institutions. As for the entities listed on BSE, five of the most commonly reported key audit matters represent 60% of the total number of key audit matters identified following our analysis.

Although the most commonly reported key audit matter is related to revenue recognition, the presumed fraud risk indicated by ISAs in connection with revenue recognition has not been presented as such in all the reports analyzed. Revenue recognition was considered a key audit matter due to specific reasons, such as the complexity of the accounting treatment, the use of estimates for revenue recognition and the use of manual procedures for bookkeeping a high volume of transactions.

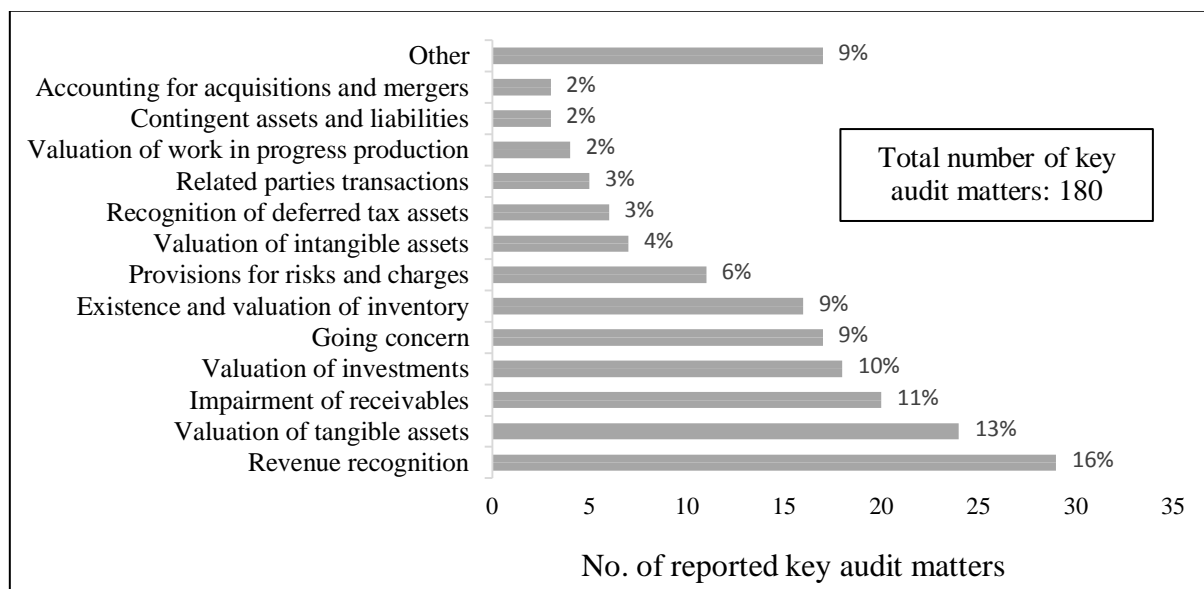
Also, we do not find it surprising that the most important key audit matters reported by the auditors include the impairment for property, plant and equipment and receivables, since the accounting treatments applicable to them require a high level of professional judgments from the management, including the use of estimates with regards to uncertain events or conditions. In order to reduce the risk of material misstatement in relation to these, the auditor should obtain corroborative evidence

of the management's assessment and also to exercise an appropriate level of professional skepticism to verify its accuracy.

The impairment for receivable balances represents the most commonly reported key audit matter also for the credit institutions. The manners in which the banks estimate the loss adjustments due to the debtors' risk of default imply a complex process where several estimates, statistical analysis and a high level professional judgment from the management's side are used.

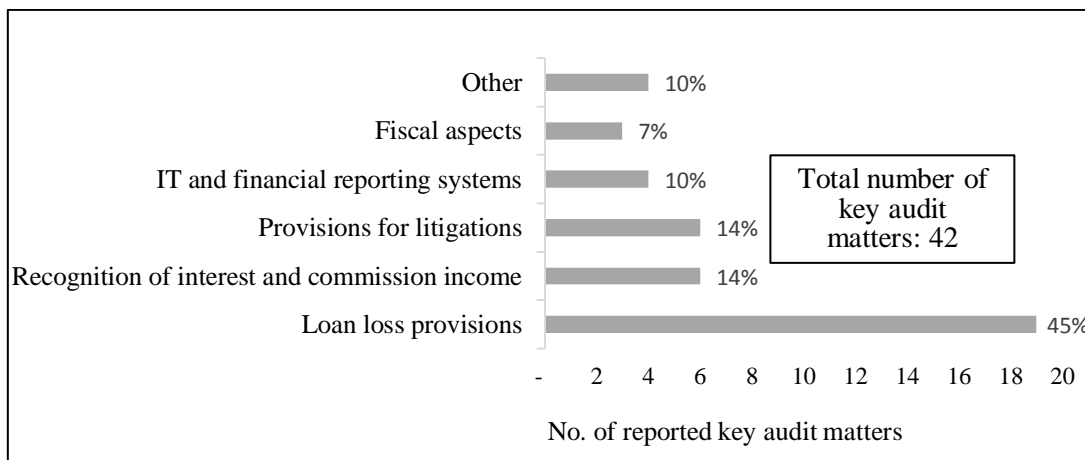
Contrary to most of the entities listed on BSE, credit institutions have complex IT systems that ensure the bookkeeping of a high volume of transactions on a daily basis, including the automatic bookkeeping of interest and commission income deriving from the lending activity. However, the auditors considered appropriate to include interest and commission income recognition among the key audit matters as these revenues represent the most significant part of a bank's turnover. As for the impairment for receivables, the provisions for litigations have been identified as key audit matters given the high level of professional judgment required from the management's side and the use of estimates with regards to uncertain events or conditions.

Figure no. 3. Key audit matters based on their nature – entities listed on BSE



Source: Author's own analysis

Figure no. 4. Key audit matters based on their nature – credit institutions



Source: Author’s own analysis

The results of the research reveal that, for public interest entities, the audit companies E&Y and PwC reported a higher average number of key audit matters than the 2.4 average identified at the level of the entities listed on BSE. We also noticed that Deloitte, BDO and Mazars reported, on average, a similar number of key audit matters. As for the credit institutions, E&Y and PwC reported an average of 2.8 and 2.4 key audit matters, higher than the 2.1 average recorded at the level of the credit institutions included in the analysis.

According to ISA 701, in order to conclude that certain aspects communicated between the auditors and those charged with governance are key audit matters, the auditors should consider a number of aspects, including the importance of these aspects for the stakeholders’ understanding of the financial statements and, in particular, its materiality for the financial statements as a whole. In this sense, during our analysis, we observed that, in certain situations, the auditors considered appropriate to disclose the value of the materiality used to conduct the audit, together with a description of the calculation methodology.

From another analysis, we observed that PwC Romania is the only local audit company that chose to present the value of the materiality used throughout the audit process in all the audit reports issued in connection to the financial statements for the financial year ending 31 December 2017 of the entities included in the sample.

Conclusions

Auditors have been required to issue standard audit reports for many decades. Moving to an environment of bespoke auditor’s reports is undoubtedly changing this long-established culture in the auditing profession.

The implementation of the new and revised auditor reporting standards poses significant challenges to auditors, to management of the entities and those charged with governance because the preparation of the auditor’s reports could not be undertaken without their involvement. These challenges at the same time provide opportunities for the development of the audit profession so that auditors can provide greater insights into their work and improve the relevance of their audits for the benefit of entities and their stakeholders. Entities can also take the opportunity to enhance their financial statements disclosures and to stimulate dialogues with their stakeholders in particular on those matters that are considered significant by the auditors.

The research revealed that the auditors complied with the new ISAs requirements regarding the format and content of the audit report, except for three situations where the auditors considered that there are no key audit matters to report. In the future, it is interesting to observe whether the auditor’s approach for the concerned entities will undergo changes. Also, the results of the study indicate different approaches of the

audit firms in terms of the number of key audit matters reported and the disclosure of the materiality level used during the audit process.

Considering the fact that the extended audit reports were issued only for two financial years (namely 2016 and 2017), auditors are expected to analyze the changes needed to improve the content of the reports based on the experience already gained, in particular for the presentation of key audit matters. It is also expected that entities will continue to develop their corporate governance practices and disclosures from financial statements and annual reports in order to meet increased stakeholders expectations.

Regarding the research limitations, we consider that one of the limitation is represented by the lack of the audit reports for two of the credit institutions, legal entities, operating on the Romanian market and for the three branches of foreign credit institutions, whose financial statements are prepared by the parent company. However, given their weight in the total sample, we consider that the results obtained are not significantly influenced.

With regards to future research directions, we aim to continue the research with identifying and analyzing the key audit matters reported by the auditors of entities operating in other industries.

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