

External audit in the function of providing assurance in the correctness of the assumptions about the going concern assumption

Eksterna revizija u funkciji pružanja uveravanja u ispravnost pretpostavke o načelu stalnosti poslovanja preduzeća

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Abstract

Expressing confidence in the correctness of the going-concern assumption of the client's company is a complex issue that requires attention. Based on the company's characteristics, auditors may indicate the problem of business continuity, but the uncertainty of future events that may affect the company to initiate or not to initiate bankruptcy proceedings remains. The client and the auditors bear the consequences of expressing a wrong opinion. The aim of the paper is to emphasize the auditor's responsibility in expressing opinions on the principle of the going-concern assumption, as well as drawing attention to the consequences that the auditor's opinion can cause. By reviewing literature and audit practices in different countries, the authors concluded that expressing a modified opinion expressing doubts about the continuation of business directly makes it difficult to conduct its business activities (it is harder to approve loans, find business partners, etc.). In this way, the chances of the company recovery are reduced. On the other hand, expressing an unmodified opinion, following which the client company opens bankruptcy proceedings, causes public dissatisfaction and suspicion in the auditing profession. Although users of financial statements expect an auditor's warning about the company's financial difficulties that lead to the initiation of bankruptcy proceedings, the auditor's responsibility is to express an opinion on whether the continuity of business is endangered and not whether the company will initiate bankruptcy proceedings.

Keywords: audit, going-concern assumption, modified opinion, auditor's responsibility, auditor's independence

Sažetak

Izražavanje uverenja u ispravnost pretpostavke o načelu stalnosti poslovanja preduzeća klijenta predstavlja kompleksnu problematiku koja zahteva pažnju. Revizori na osnovu karakteristika preduzeća mogu ukazati na problem stalnosti poslovanja, ali ostaje neizvesnost budućih događaja koji mogu uticati na preduzeće da pokrene ili ne stečajni postupak. Posledice izražavanja pogrešnog mišljenja snose klijent i revizori. Cilj rada jeste ukazivanje na odgovornost revizora u pogledu izražavanje mišljenja o načelu stalnosti poslovanja, kao i skretanje pažnje na posledice koje može izazvati mišljenje revizora. Pregledom literature i prakse revizije u različitim zemljama, autori su došli do zaključka da se izražavanjem modifikovanog mišljenja po kojem se izražava sumnja u nastavak poslovanja, direktno se otežava odvijanje poslovne delatnosti preduzeća (teže se odobravaju krediti, pronalaze poslovni partneri i sl). Na taj način, šanse za oporavak preduzeća se smanjuju. S druge strane, izražavanjem nemodifikovanog mišljenja, nakon čega preduzeće klijent otvara stečajni postupak, izaziva nezadovoljstvo javnosti i sumnju u revizorsku profesiju. Iako korisnici finansijskih izveštaja očekuju upozorenje revizora o finansijskim teškoćama preduzeća koji dovode do pokretanja stečajnog postupka, odgovornost revizora je u tome da izrazi mišljenje da li je stalnost poslovanja ugrožena, a ne da li će preduzeće pokrenuti stečajni postupak.

Кljučне речи: revizija, pretpostavka o načelu stalnosti poslovanja, modifikovano mišljenje, odgovornost revizora, nezavisnost revizora.

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1. Introduction

The importance of professional and legislative regulations for ensuring the quality of financial reporting arises from the importance of financial reports for users. One way to achieve the appropriate rate of financial statements is to apply generally accepted accounting principles and standards. Another way is to conduct an external audit. Based on the external auditor's report, the users of the financial statements gain additional assurance that the financial statements present an accurate and fair view of the assets, capital, liabilities and results of operations of the company. Due to an impartial opinion on the reliability of data and objectivity of financial statements, the audit report "adds value" (Hodžić, & Gregović, 2016, p. 116) for users to whom financial statements are the information basis for business decision-making.

In addition, it is of the utmost importance for the beneficiaries of financial statements to express the auditor's suspicion regarding the continuation of the company's operations in the future and highlight the factors that led it to express doubt. The auditor's opinion should not be taken as predicting the failure of the company's operations but as a warning signal on the business and sustainability of financial stability (Carson et al., 2017).

The auditor's expression of the auditor's suspicion of continuing to do business is influenced by various factors. By reviewing financial statements, auditors and data credibility gain insight into the company's financial operations by analyzing financial variables. Typically, liquidity problems are thought to increase the likelihood of financial failure (or bankruptcy in the short term), while the problem of profitability can lead to bankruptcy in the medium or long term. However, the results obtained by Desai et al. (2020) demonstrate a greater willingness of auditors to express doubts about the continuation of operations precisely because of the problem of profitability. The authors examined 2921 going-concern modified audit opinions from 1999 to 2015 in the United States. They wanted to determine the extent to which the following factors led to the auditor's modified opinion: profitability, liquidity, cash flow, solvency, technical default, and payment default. The survey results showed that profitability factors are listed in 81% of audit reports, while liquidity problems are found in 56% of audit reports.

An auditor's opinion leads to a series of consequential reactions between the client and the beneficiary of the financial statements. The auditor balances between the client and the client's desire not to express doubts about the continuation of the business and the auditor's obligation has to act independently and in the interest of all financial market participants (Geiger & Kumas, 2018). A modified audit report expressing doubt about the continuation of the business leads to an adverse reaction from the share price, driven by institutional investors (Menon & Williams, 2010). Since the client does not want to get an opinion that will cause the company's market

value to decrease, he often fires the audit firm and hires a new one (Carcello, & Neal, 2003). If it is a significant and large company, the newly elected audit firm will enhance its reputation, leading to higher premiums. In addition to attracting new clients, auditors' reputation is enhanced by retaining existing clients and conducting high-quality audits. On the other hand, an unsuccessful audit reduces the auditor's reputation, which the auditing firm bears. It suggests that auditors voluntarily ensure the appropriate audit quality level (Ball, 2009). Due to dependence on premiums and customer retention, small audit firms are most often tempted to sacrifice objectivity and independence in expressing opinions (Chi et al., 2012).

A high-quality audit requires teams with comprehensive knowledge, and auditing firms provide other non-revision services besides audit services. However, Cook et al. (2020) believe that achieving revenue by providing non-revision services can lead to a sea of lenient auditing. Many authors see the problem of auditors' independence as providing audit and non-audit services to the same client. Other authors believe that the auditor's knowledge of the client's operations is expanded by providing different services, thus raising the audit's quality. Nevertheless, the Lai (2021) survey results show that auditors are more likely to express a modified opinion if, in addition to audit services, the client has not hired him for the services of tax consulting (auditor-provided tax service).

The paper aims to highlight the auditor's responsibility to express doubts about the company's continued operations and draw attention to the consequences that the auditor's opinion can cause. In this way, auditors' independence plays a crucial role in making the correct opinion and achieving a quality review. The paper is organized as follows: In Section 2, the audit's responsibility is to express opinions regarding the assumption of the permanence of the business. Section 3 describes forms of audit report and determinants that determine the audit report. Section 4 underscores the inability to retain the auditor's independence for the quality of the audit report while citing examples of poor audit practices around the world. The last section contains the basic conclusions of the work.

2. Auditor's responsibility regarding the assumption of consistency of operations

Auditors are responsible for planning and conducting the audit by professional and legal regulations, respecting ethical standards. Based on the audit evidence, they express an impartial and objective opinion on whether the financial statements have been prepared by the prescribed regulations and whether they present an accurate and fair financial position of the company on all material matters. The essential task set before them is to prevent the disclosure of incorrect financial information (Jovanović-Škarić, 2011, p. 10). Incorrect information may be the result of accidental or intentional errors. When the management body intends to deceive the public into the correctness of the financial statements, it is sometimes

difficult to detect fraud carried out in the company. Therefore, auditors believe that their responsibility should not cover fraud detection actions (Alleyne & Howard, 2005, p. 285).

Auditors are also not responsible for predicting the future performance of a client company. However, for many users of an audit report, an early warning of a crisis in the company is the most important and valuable result that auditors provide (Casterella et al., 2000, p. 508). Beneficiaries' expectations related to the auditor's impartial assessment of the sustainability of the going-concern assumption. Beneficiaries also expect an auditor's warning about the company's financial difficulties that lead to the initiation of bankruptcy proceedings. However, auditors should anticipate whether business continuity is compromised, not whether the firm will initiate bankruptcy proceedings (Kennedy & Shaw, 1991, p. 97).

International Standards on Auditing IAS 570 (Principle of Consistency) developed by the International Audit Practice Committee (IAPC), within the International Federation of Accountants (IFAC), defines the auditor's responsibility for gathering sufficient adequate evidence and performing conclusions based on them on "whether there are material uncertainties regarding the entity's ability to continue as a going concern" (IAASB, 2016, par. 6). The standard also provides examples of situations that may indicate a suspicion of a violation of the assumption of business continuity in the future. For instance, within finance, these may be unfavorable key financial indicators or significant operating losses. Within the business, these can be losses of top management, markets, labor or raw materials. Non-compliance with legal regulations, litigation, etc., may also be an indication of a breach of presumption (IAASB, 2016, par. A3).

According to Statements on Auditing Standards - SAS no. 59 (AICPA), issued by the American Institute of Certified Public Accountants - AICPA, the auditor is responsible for assessing whether there is significant doubt about the client's ability to continue doing business for a reasonable period (no longer than 12 months from the date of the financial statements). The auditor's assessment is based on knowledge of the conditions and events that exist or occurred before the opinion was expressed.

3. Audit reporting for going-concern uncertainty

The determinants that determine the audit report can be divided into four categories (Carson et al., 2013, p. 357):

- Client characteristics. The auditor uses financial and non-financial variables to assess the client's ability to continue as a going concern, using a variety of models to predict business failure.
- Characteristics of the auditor. Fear of losing the client or a possible lawsuit of the client, as well as the inexperience of the auditor can affect the expression of, most often, an unmodified opinion. On the other hand, auditors who specialize in a particular

economic activity more often express a modified opinion on the principle of business continuity.

- Interaction in the client-auditor relations. Family or personal relationship between the client and the auditor, a significant amount of compensation received from the client or the duration of the engagement may be reasons for the auditor not to question the viability of the business continuity assumption.
- Environmental characteristics. The effects of changes in audit regulations and the application of punitive measures against auditors may contribute to a higher percentage of modified audit reports. However, greater competition from audit firms and the struggle for a share of market profits may reduce the quality of audits and affect the increase in the number of unmodified reports, i.e. reports that do not express doubts about the client's continued business.

Expressing an unmodified opinion for certain companies that initiated bankruptcy after publishing the audit opinion causes public dissatisfaction. The auditors defend themselves by explaining that only for companies that are evidently in financial problems, they express an opinion on the uncertainty of business continuity. All others have elements of sound business and do not show many signals of financial problems (Casterella et al., 1999, pp. 169-177). Feldmann and Read (2010) investigated whether for companies that initiated bankruptcy proceedings, auditors expressed significant doubts about business continuation (pp. 267-278). Compared to 2001, of the 257 companies that filed for bankruptcy in that year, 53% had a modified audit opinion in the year before the bankruptcy. In 2002, there was a significant increase in modified audit reports, by 72% compared to 175 companies in bankruptcy. The following year, the number of modified reports decreased until 2009, amounting to about 52% of the total number of companies that filed for bankruptcy in that year. Desai et al. (2020) believes that the link between the auditor's modified opinion and the subsequent bankruptcy filing is stronger just before the sox or the onset of the global financial crisis.

Expressing doubts about the continuity of the client's business is a complex issue that requires attention. Although auditors can point to business continuity problems based on the company's characteristics, the uncertainty of future events that may affect the company to initiate or not to initiate bankruptcy proceedings remains uncertain. Therefore, the client and the auditors bear the consequences of expressing a wrong opinion. There are two forms of the erroneously expressed opinion of the auditor that refers to the assumption of business continuity (Jakšić & Mijić, 2017, p. 192):

- The auditor may express a modified opinion that there is significant doubt about the client's ability to continue as a going concern for a reasonable period and that the client is going to continue the business for less than 12 months from the date of the financial statements (type I error). Excessive caution can lead an auditor to make a mistake of this type, believing

that greater harm to the public can be done by not expressing such an opinion. According to some earlier research, less than 20% of companies whose auditors expressed a modified opinion opened bankruptcy proceedings in the first year after expressing opinions (Geiger & Rama, 2006; Desai et al., 2020). On the other hand, despite the pronounced financial problems, the company does not have to initiate bankruptcy proceedings, directly contradicting the audit report.

- The auditor may express an unmodified opinion that there is no doubt in the client's ability to continue as a going concern for a reasonable period and for the client to file for bankruptcy in less than 12 months from the date of the financial statements (type II error). An error of this type usually occurs due to insufficient auditor independence. In addition, awareness that the expression of a modified opinion affects the fate of the company (loss of stakeholder confidence in the continuation of the company's business makes it challenging to conduct business) may contribute to the wrong audit conclusion.

In the review of audit reports in the United States from 2003 to 2008, the percentage of modified reports on the problem of business continuity about the total number of audit reports steadily increased from 16,39% in 2003 to 21% in 2008, while in 2009 slightly decreased and amounted to 19,45% (Cheffers et al., 2010). Carson et al. (2011) examined the frequency of expressing a modified audit report expressing the uncertainty of business continuity in Germany, the United Kingdom, Australia, France, and the United States from 2001 to 2009. The authors concluded that there is a difference between the examined countries and that Germany is the readiest to express a modified opinion. It is monitored by Australian auditors, while UK auditors are the least willing to express a modified opinion. The difference of opinion can be partly explained by the different legal regulations related to the audit. With the strengthening of harmonization, the differences in the frequency of expressing the modified opinion of the surveyed countries decreased, and the willingness of auditors to express doubts about the continuation of clients' business increased. Mareque et al. (2017) examined whether the financial crisis contributed to the increase in modified audit reports in Spain from 2007 to 2010 (pp. 154-183). The authors found that compared to 2007, when the crisis did not manifest itself, later in its heyday there was an increase in audit reports that warn of the sustainability of business continuity.

Gutierrez et al. (2019) consider that the auditor's opinion on the violation of the business continuity assumption increases the predictive power of the models used to predict the initiation of bankruptcy, based on financial ratios, market variables and credit rating. Model improvement has a particularly positive effect on type II error. Despite findings that there is a great revision in predicting the permanence of private Swedish firms, Alexeyeva and Sundgren (2021) have also seen a high error rate of Type II in their results. The authors believe that the consequences of a Type II error are less than the consequences of a Type I error due to fears of a potential

self-fulfilling prophecy effect (Alexeyeva & Sundgren, 2021).

The desire for better interaction of auditors with the client and stakeholders has led to the improvement of the audit report by adopting new and revision of existing auditing reporting standards, which began to apply on December 15, 2016. Therefore, the improved audit report should contain (Bonić et al., 2019, p. 333):

- prominent opinion of the auditor at the beginning of the audit report, as the most essential part of the report for stakeholders;
- precisely stated grounds for opinion, such as standards, ethical principles and derived evidence based on which the auditor's opinion is expressed;
- responsibility of the manager for the assessed information on the continuation of business;
- highlighted key audit issues that highlight how the auditors performed the audit, what is good and what needs to be corrected in the work of the client, etc;
- highlighted other information that allows for a better understanding of the audit;
- responsibility of the manager for management, financial reports and assessed ability of the company to continue operations;
- the auditor's responsibility for independence and ethical obligations, and
- indication of engagement partners.

Significant issues for assessing the sustainability of the assumption of business continuity with the client, which are regulated by changes in the standards of audit reporting in the audit report are presented (Bonić et al., 2019, p. 334):

- "unmodified opinion - when material uncertainty about future operations is appropriately disclosed in the financial statements, but the auditor draws attention to those uncertainties and the note in which management declares it;
 - qualified opinion - when the auditor concludes that there is material, but not fundamentally significant uncertainty regarding the continuation of operations and that there is inappropriate disclosure in the financial statements,
- negative opinion - when the auditor concludes that there is material and fundamentally significant uncertainty for the continuation of operations, and the financial statements do not disclose those uncertainties that may affect the company to have a problem with the continuation of operations in the future".

4. Independence as a prerequisite for a quality audit report

In addition to expressing an opinion on the sustainability of the business continuity assumption, the public expects the auditor to express an opinion on whether the financial statements have been prepared by professional and legal regulations and as such represent an objective presentation of funds, sources of funds and business performance. Report users in particular expect the audit report to assure them that the reports do not contain elements of creative

financial reporting that knowingly impair their objectivity. Therefore, expressing an unbiased opinion on the reliability of the financial statements and the sustainability of the going concern assumption requires an independent and quality audit.

The independent auditor has a crucial role in protecting users of financial statements from the unfair intentions of the company's governing body. But the key to auditor independence lies precisely in the nature of the relationship between the auditor and the management body of the client company. In conditions of high competition from audit firms, auditors can make a compromise - keep the client and turn the blind eye when it comes to situations that disrupt the credibility of financial statements. The pressure on auditors' independence is more significant when auditors provide services other than audit services, which increases the auditor's fee. By not deciding to respect ethical norms but for personal profit, auditors can harm investors and the general public. For example, (Schilit & Perler, 2010, p. 35): the accounting firm Arthur Andersen had 85.000 employees in 84 states and generated \$9 billion in revenue in 2001. Enron was the only one to audit financial statements for 16 years. In addition to external audit, it provided Enron with internal audit and consulting services. After the crash of Enron, it destroyed the documents on the audit of financial statements and was convicted of obstructing the investigation and destroying the evidence, after which the auditing company Arthur Andersen ceased to exist. In Parmalat, for example, auditing for too long by one house (Grant Thornton) and close interpersonal relationships have affected auditors' independence and non-detection of criminal activity. As Italian law mandated a change in the audit firm after nine years of auditing, the newly hired audit firm Deloitte & Touche uncovered non-existent offshore accounts and other illegal actions. The PricewaterhouseCoopers subsidiary audited the financial statements of the Japanese company Kanebo without revealing a reported non-existent profit of two billion dollars in the period from 1996 to 2004. As a result, a lawsuit was filed against the auditor and a two-month suspension of operations (Schilit & Perler, 2010, p. 36). In Parmalat, too long an audit by a house (Grant Thornton) and close relationships have affected the independence of auditors and the non-disclosure of criminal acts. As Italian law ordered a change in the audit house after nine years of auditing, the newly hired auditor at Deloitte & Touche exposed dishonest offshore accounts and other illicit acts. In order to save the Parmalat group, a new bankruptcy procedure known as „extraordinary administration“ was introduced. Modeled on Italian Legge Marzano, this procedure has also been introduced in Croatia to save Agrokor. The demise of one of Croatia's most significant companies would cause systemic problems for the country's many stakeholders and economy. An investigation has been launched against members of the board of directors and supervisory boards and two auditors from the auditing firm Baker Tilly for unlawful acquisition of financial gain. Newly appointed auditing firm PricewaterhouseCoopers

found the company's debts were \$14.5 million croatian kunas larger than capital (Đurić & Jovanović, 2019).

Klein (2002) explored the relationship between auditor independence and the activities of managers to adjust earnings. The research results showed that the auditor's independence has a negative impact on earnings management. When auditors comply with professional regulations and follow ethical principles, there is no obstacle that may lead auditors to fail to disclose the facts or conceal facts. This confirms the view that the auditor's independence provides additional certainty in the reliability of the audited financial statements.

The auditors' independence may also be affected by the amount of fees that auditors charge to client companies. Independence is more compromised if the total fees by one client represent a significant portion of the audit firm's total revenue. A higher fee may cause auditors to “close their eyes” to certain omissions and, for personal gain, reduce the quality of the audit. Some authors agree that higher compensation facilitates audit quality (Choi et al., 2010; Chi et al., 2012; Blay & Geiger, 2013). However, there is an opposite attitude in the professional public. Doogar et al. (2015) state that the high fee actually represents the costs of performing the audit and that it does not change with the change of the audit firm, and as such does not affect the independence of the auditor (p. 1278). Hoang et al. (2019) link the amount of the fee with the expertise of the auditor. Depending on the competencies of hired auditors, the amount of compensation varies for individual engagements. The authors have shown that assigning leading senior audit managers contributes to greater engagement profitability.

Except for impaired auditor independence, failure to detect material errors and fraud may result from the auditor's low competence, knowledge and experience. Malone and Roberts (1996) explain poor or incorrect audit activities as activities of auditors that result in inadequate and unreliable evidence on which they express an opinion. The public expects auditors of high quality, reputation, knowledge, and experience to more easily detect intentional or unintentional errors in the financial statements and inform the public about it through the audit report. From this point of view, a high-quality and efficient audit prevents fictitious and inaccurate financial statements. Their disclosure damages the reputation of the client company and the market value of the capital. Becker et al. (1998) examined the impact of audit quality on earnings management through discretionary calculations. The authors started from the assumption that the auditors who belong to the group of the six largest audit firms (Big Six) are of high quality, unlike the auditors who do not belong to the given group. The research results showed that clients of auditors who do not belong to the group of the six largest audit firms report more discretionary accounts than clients of high-quality auditors, which leads the authors to conclude that lower audit quality is associated with greater “accounting flexibility”. In addition, Francis et al. (1999) state that the six largest

audit firms limit the aggressive accounting approach to profit-taking (p. 17).

Building reputations and attracting new clients on the Serbian market is especially difficult for newly established auditing firms whose business results are below average, with a fluctuation in profitability. On the other hand, audit firms belonging to the “Big Four” dominate the Serbian market, with uneven participation of business income, number of employees, and net profit in the structure of the total number of audit firms (Jakšić et al., 2012). Mijić and Rađo (2021) examined the profitability of audit firms in Serbia and established a growth trend for the period 2016-2018. They also concluded that belonging to an international network has a significant positive impact on the profitability of audit firms operating in Serbia.

Changing audit firms is not a rare occurrence in Serbia either. The survey found that businesses that received unqualified audit opinions in the initial period and changed their audit ingredients were less likely to get the same auditor's opinion in subsequent periods than companies that did not change the auditor (Stanišić et al., 2014).

The reliability of audit reports is also their timely disclosure. The survey found that Serbia does not deviate too much from other countries regarding the minimum number of days late in publishing the audit report. However, the maximum number of days of delay reaches up to 355 days. In addition, the authors note that companies whose audit was conducted by Big Four audit firms have longer ARL (Audit Report Lag) in Serbia concerning audit reports from other audit firms (Obradović et al., 2018). Based on Mizdrakovic et al. (2020), approximately three-quarters of the companies whose financial statements were subject to audit from 2016-2018. In 2013, it received an unqualified auditor's opinion. Half of the audits carried out were entrusted to domestic audit firms.

5. Conclusion

Independent and quality audit contributes to an impartial and objective opinion on the reliability of the financial statements and significant doubts about the viability of the assumption of the continuity of the company's operations. In that way, a safer information base for making business decisions is provided.

The auditor's responsibility refers to assessing the existence of a significant doubt about the client's ability to continue operating in the future (which should not be longer than 12 months from the date of the financial statements). Auditors can express doubts about continuing operations based on significant business losses, market losses, labor or raw materials, lack of compliance with legal regulations, large and unfavorable litigation, etc. However, fear of losing the client or a possible lawsuit by the client, the compromised principle of independence, and inexperience of auditors may lead to auditors more

often expressing an unmodified opinion that auditors do not express doubts about the client's business continuity.

Based on previous research, the authors concluded that there is a difference in the frequency of expression of the modified report between states. However, by strengthening harmonization, differences in the frequency of expressions of modified opinion are diminishing, and the willingness of auditors to express doubts about the continued business of clients is increasing.

By reviewing the literature and audit practices in different countries, the authors concluded by expressing a modified opinion expressing doubts about the continuation of the business. It directly makes it difficult to conduct the company's business activities (it is harder to approve loans, find business partners, etc.). In this way, the chances of a company recovery are diminishing. On the other hand, expressing an unmodified opinion, after which the client opens bankruptcy proceedings, raises public discontent and doubts about the audit profession.

Given that inadequate expression of the audit opinion, i.e. that type I and type II errors leave consequences on the future activities of the client, auditor and user of financial statements, it is proposed and adopted in 2016 to amend the standards that improve the audit report. The enhanced report clearly highlights the auditor's opinion, the basis for issuing the opinion, his or her responsibility to express doubts about the continuing operations, and other information that allows for a better understanding of the audit.

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