finiz
Singidunum University International Scientific Conference
Međunarodna naučna konferencija Univerziteta Singidunum

CONTEMPORARY
FINANCIAL MANAGEMENT

UPRAVLJANJE FINANSIJAMA U
SAVREMENIM USLOVIMA
POSLOVANJA

DOI: 10.15308/finiz-2015-88-91

THE ANALYSIS OF AUDITORS' REPORTS IN RELATION TO THE CLIENTS' SOLVENCY LEVEL

Nada Arežina*, Vule Mizdraković, Ljiljana Jeremić
Singidunum University, Faculty of Business in Belgrade, 32 Danijelova Street, Belgrade, Serbia

Abstract:
Public companies and their business operations represent an important segment of the economic system of a country and they could have a significant impact on its further economic growth. Therefore, these companies should have a stable financial structure and be a model of high-quality financial reporting, or else they could greatly impede smooth functioning of other stakeholders on the market. With respect to that, the auditor is expected to provide going concern assessment in his/her report in order to timely alert any red flags related to this issue. The purpose of this paper is to analyse the solvency level and its impact on the type of auditor's opinion. Therefore, the research sample included 196 auditor's reports on 50 public companies in Serbia for the period 2010-2013. The research sample was further divided into two groups, solvent and insolvent, based on which we have determined the most frequent matter in the auditor's opinion. Moreover, we have noticed that unqualified opinions with explanatory language make up half of the total, unqualified audit opinions, with going- concern issue being most frequently addressed.

Key words:
public companies,
financial statement audit,
auditor's opinion,
solvency,
going-concern.

1. INTRODUCTION

Changes in the expectations of society and technology, but also a series of accounting scandals in almost all sectors of the economy, have made the role of auditors more accountable. The public is expecting auditors to be the guardians of proper and continuous functioning of the entity's business or going concern assumption. Therefore, an entity is considered as continuing business if it is able to carry on its operations in the foreseeable future. Auditor's contribution in that sense is to prove the credibility of financial statements, which means that they are presented truly and fairly, as well as reliable, for all stakeholders. In this manner, auditors should state in their reports if there are any intentional material misstatements that could mislead users in making proper decisions. Nevertheless, an auditor should disclose red flags or state if there are any indications, that could be a sign of heightened risk related to future entity's operations.

Different authors stated that many entities collapsed unexpectedly, soon after they have published financial statements showing financial issues (Margret, 2012). This could be a significant issue and concern for the managers and owners, and especially for investors who require that their investments provide adequate returns in the future. Thus, auditors should provide necessary information about the financial ability of an entity to reimburse its debts, but at the same time, be able to continue its business operations. Nevertheless, it is important to emphasize that solvency, as defined above, differs from liquidity. Namely, liquidity presents the entity's ability to meet its short-term obligations, because in the opposite situation entity might be forced to file for bankruptcy. Therefore, the entity can be illiquid, but at the same time insolvent. When an entity can no longer meet its financial obligations it becomes insolvent, which leaves it with no other option but to enter bankruptcy in order to salvage its business or liquidate its assets and reimburse its creditors. According to the International Standard on Auditing 570 – Going Concern, the auditor should obtain appropriate audit evidence on the possible material uncertainty about the client's ability to continue as a going concern (IFAC, 2010). Also, the auditor should consult the client's management in case of endangered going concern business. In case of material uncertainty, the auditor should state his concerns in the auditor's report. The aforementioned standard provides instructions regarding the disclosure in the form of emphasis of matter within all types of reports. Moreover, the going concern uncertainty can be used as a basis of qualified and adverse opinion. The responsibility of public companies to present fair financial statements is even more pronounced and therefore, auditing legislations require auditing of their financial statements as mandatory. In that sense, we have focused our research on public companies, their solvency level and related auditor opinions. The aim of this paper is to point out the most common notes, that auditors address, related to the client's solvency level. The contribution of this research is to comprehend the importance of the client's solvency level and its correlation to the notes addressed by auditors in their reports.

E-mail: narezina@singidunum.ac.rs

In the time of global financial crisis, bankruptcy rates tend to increase in comparison to the period of economic stability. Having in mind that the global economy has faced several similar crises over the last decade, the auditor's role in signalizing the businesses that will soon become bankrupt is of utmost importance. Namely, in such economic conditions public eyes turn to the auditors and their role as *watchdogs*, due to the reason they did not provide reports in which they disclosed concern regarding the clients' going concern (Geiger, Raghunandan, & Riccardi, 2014). Namely, several business entities filed for bankruptcy, without receiving modified auditor's opinion regarding the going concern requirement (Sikka, 2009). Research conducted by Geiger, Raghunandan, & Riccardi (2014), on 414 entities that entered bankruptcy in the period 2004-2010, showed that a much greater percentage of entities that received going concern opinion on their last set of financial statements after the start of global financial crisis, rather than those that went bankrupt during the period before the crisis. The aforementioned proves that auditors were more cautious in auditing in the post-crisis period. Due to the vital role of public companies, most regulating institutions impose restrictions regarding the type of the auditor's report. Likewise, Securities Exchange Commission (SEC) precludes publicly traded companies from releasing financial statements with any audit opinion except unqualified (Czerney, Schmidt, & Thomspon, 2014). Also, financial institutions could do the same and ask for unqualified audit opinions, when approving loans to their clients. In this manner, the auditor's inclusion of explanatory language in an unqualified report could signal a higher risk of financial statement misstatements including the high uncertainty of going concern (Cyerney, Schmidt, & Thomspon, 2014). Having that in mind, we have analyzed separately unqualified reports and unqualified reports with explanatory language.

2. RESEARCH RESULTS

In order to accomplish the goal of this paper, we have conducted research which included content analysis of auditor reports of 50 public companies from the Serbian stock exchange. The auditor reports and corresponding financial statements of Serbian business entities are publicly available for download at Business Registers Agency's website. We have collected financial statements for the period 2008-2013, however, audit reports are available only for the period 2010-2014. Therefore, the total number of observations in this research equals 196 in total. Sampled entities belong to the large-sized groups of legal entities as per classification defined by the national law on accounting. The next step was to determine solvency levels of the sampled entities. We have decided to use a debt ratio as a solvency indicator which is calculated as a percentage of total liabilities in total assets. By analyzing the results presented in the research conducted by Stanisic, Radojevic, Mizdrakovic and Stanic (2012) on 53,996 business entities in Serbia, it can be concluded that sampled entities that had a debt ratio between 0.7 and 0.8 had a significant increase in the percentage of bankrupt entities. Therefore, it can be concluded that business entities that have a debt ratio higher than 0.75 could be considered insolvent in the Serbian market and face a high solvency risk. Regarding the type of auditor's opinion, we have classified them as follows:

0. Unqualified Opinion without Explanatory Language,
1. Unqualified Opinion with Explanatory Language,
2. Qualified Opinion,
3. Disclaimer of Opinion Report and
4. Adverse Opinion.

We would like to point out that the use of explanatory language is not only reserved for the unqualified opinion, since we have found it in all other types.The results are presented in the following table.

In the table shown below, we can find all types of auditors' opinions for the period 2010-2013, classified for solvent and insolvent entities. The threshold for this classification is a debt ratio valued at 0.75, as it has been previously explained in the research methodology. It is interesting to notice that the average debt ratio of solvent entities decreased slightly over a period, except in 2012. The explanation could be the

Table 1. A Content Analysis of Auditors' Reports of Public Companies Classified as Solvent and Insolvent

Year	2010		2011		2012		2013		Total
	Solvent	Insolvent	Solvent	Insolvent	Solvent	Insolvent	Solvent	Insolvent	
0	12	2	9	1	13	3	10	2	52
1	8	3	11	3	7	1	11	6	50
2	8	6	7	8	9	8	4	10	60
3	1	7	1	6	0	9	0	5	29
4	0	1	0	2	0	0	1	1	5
Total	29	19	28	20	29	21	26	24	196
Average Debt ratio	0.5379	1.2563	0.5195	1.3458	0.5219	1.6465	0.4641	1.7426	/
Average current ratio	1.4506	0.6423	1.4034	0.5627	1.4521	0.5607	1.6522	0.4327	/
Going concern	3	12	4	14	4	17	5	19	78
Mortgage	3	5	4	8	5	5	5	5	40
Interest-bearing debt to assets	0.2423	0.7013	0.2177	0.7189	0.2277	0.7837	0.1924	0.7725	/
Current assets lower than current liability	2	5	2	10	2	9	3	10	43
Indebtedness	0	0	0	0	0	0	0	1	1
Frozen accounts	0	1	2	4	1	2	1	3	14
Restructuring	0	5	0	6	0	4	0	3	18

intention of solvent entities to avoid further indebtedness and finance their business with other means of financing. Nevertheless, , this is not the case for insolvent entities, as the value of debt ratio recorded an increase from 1.25 to 1.75, which depicts a significant deterioration of their financial structure. However, having in mind that in 2012 the Serbian market felt the strongest impact of financial crisis, both solvent and insolvent entities increased their indebtedness in that year. The aforementioned argues in favor of the increased number of going concern disclosures in the sampled auditor reports.

Also, it can be noticed that the structure of auditor's report type changes during the observed period. Namely, in 2011 the number of unqualified opinions decreased for both solvent and insolvent entities, while the number of unqualified opinion with explanatory language increased, as seen in the following chart.

The explanation for the previously stated could be the deterioration in profitability level, because as noted by Stanisic, Radojevic, Mizdrakovic and Stanic (2012), the revenue change equalled almost -10% in 2011 compared to 2010. The same authors found that public companies were mostly affected because the faced a decrease in revenues amounting to 22%. Therefore, business entities in Serbia were probably more motivated to use the techniques of negative creative accounting which could have been noticed by auditors. Unrelated to this subject, what arouse our interest is the fact that out of 196 sampled opinions, only 52% are unqualified while only 26% of them are without explanatory language, which is shown in Chart 2. This means that if there were restrictive regulations regarding the type of obtained auditor opinion for public companies, the significant number of them wouldn't fulfil requirements to be listed on the Serbian stock exchange. Public entities play an important role in economic development with numerous stakeholders whose businesses depend on their financial health. Therefore, we would like to point out that additional legal regulations in this field would enhance the quality of this particularly important group of business entities.

With regard to the going concern, the number of these statements in auditor's reports increased over the period, while the number of concerns related to the mortgage was the highest in 2011. Interest-bearing debt ratio of solvent entities varied from 0.24 to 0.19, while for the other group it varied around 0.7. The aforementioned is the indicator that insolvent entities are financed on average more than three times with interest-bearing debts compared to solvent ones. Furthermore, solvent entities on average have around 1.5 times more current assets than short-term liabilities, indicating the highest liquidity level in 2013. On the other hand, the current ratio of insolvent entities decreased from 0.64 to 0.43 in the analyzed period. This concern was also stated in auditor's reports mainly in explanatory language paragraph with the note that the liquidity level has been disrupted or that short-term liabilities have been higher than current assets.Frozen accounts, restructuring and non-performing loans were also remarks that had been included in the explanatory language, correlated with those entities classified as insolvent.

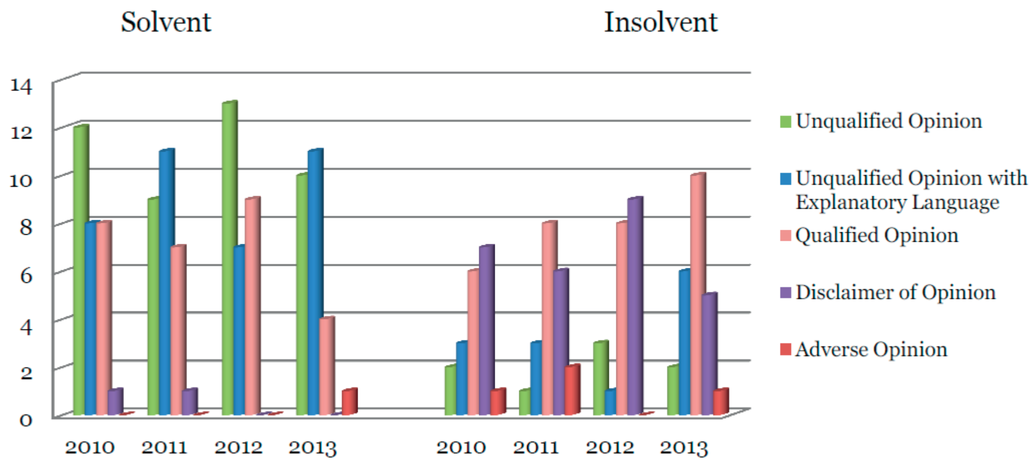

Chart 1. Types of Auditors' Opinions for Solvent and Insolvent Public Companies for the period 2010-2013.

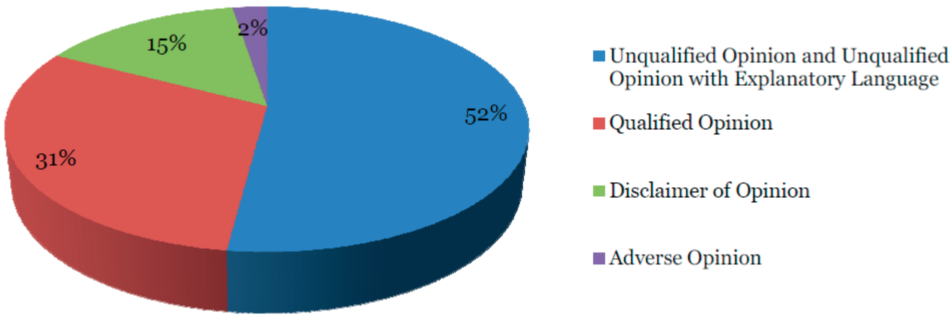

Chart 2. Types of Auditors' Opinions Issued for Sampled Public Companies for the period 2010-2013.

3. SUMMARY

The explanatory language in the auditor's report could communicate entity's solvency risk. In regard to the public companies, auditors should be particularly cautious concerning the previously mentioned issues. The research we have conducted shows that the number of going-concern notes in the explanatory language increased in the period 2010-2013, and this trend has been accompanied by an increase of debt ratio for the aforementioned period. Moreover, solvent entities have a tendency to be less indebted over the research period, while insolvent entities on average have a significantly higher debt ratio valued at 1.25 to 1.74 for the same period. This trend is followed by interest-bearing debt ratio for insolvent entities where this indicator is valued at 0.78 and 0.77 for 2012 and 2013 respectively. Furthermore, the percentage of insolvent entities increased over the period, where the number of unqualified and unqualified with explanatory language opinions accounts for only 52% of all types of sampled auditors' opinions. Additionally, a number of qualified, adverse and disclaimer of opinion increased for insolvent entities per year. This should be a very important issue because more rigorous constrictions regarding the type of auditor's opinion could reduce the number of public companies listed on the Serbian stock exchange. This gives rise to the following question: could more rigorous legislation related to the types of auditors' reports, just as in developing markets, decrease the number of companies that fulfill the imposed requirements?

REFERENCES

Czerney, K., Schimidt, J., & Thompson, A. (2014). Does Auditor Explanatory Language in Unqualified Audit Reports Indicate Increase Financial Misstatement Risk? *The Accounting Review, 89 (6)*, 2115-2149. doi:10.2139/ssrn.2245855

Geiger, M., Raghunandan, K., & Riccardi, W. (2014). The Global Financial Crisis: U.S Bankruptcies and Going-Concern Audit Opinions. *Accounting Horizons, 28 (1)*, 59-75. doi:10.2308/acch-50659

IFAC. (2010). *G5 International Standard on Auditing 570 Going Concern*. Retrieved October 18, 2015 from http://www.ifac.org/system/files/downloads/a031-2010-iaasb-handbook-isa-570.pdf

Lee Huff, P., Harper, R., & Eikner, E. (1999). Are There Differences in Liquidity and Solvency Measures Based on Company Size. *American Business Review, 17 (2),* 96-111.

Margaret, J. (2012). *Solvency in Financial Accounting*. New York: Routledge

Proklin, M., & Zima, J. (2011). Utjecaj likvidnosti i solventnosti na poslovanje poduzetnika. *Ekonomski vjesnik, 24 (1),* 72-89.

Sikka, P. (2009). Financial Crisis and the silence of the Auditors. *Accounting, Organizations and Society, 34 (1)*, 868-873. doi:10.1016/j.aos.2009.01.004.

Stanisic, N., Radojevic T., Mizdrakovic, V., Stanic, N. (2012). Capital Efficiency of Serbian Companies. *Singidunum Journal of Applied Sciences, 9 (2)*, 41-49.

ANALIZA SADRŽAJA REVIZORSKIH MIŠLJENJA PREMA NIVOU SOLVENTNOSTI KLIJENATA REVIZIJE

Apstrakt:
Poslovanje javnih društava predstavlja važan segment ekonomskog sistema jedne države. Stoga je veoma bitno da ova privredna društva budu primer kvalitetnog finansijskog izveštavanja, kao i da poseduju stabilnu finansijsku strukturu, jer u suprotnom mogu negativno uticati na nesmetano funkcionisanje ostalih učesnika na tržištu.
U tom smislu, revizor je dužan da izrazi mišljenje o postojanju pretpostavke kontinuiranog poslovanja (*going-concern*), kako bi blagovremeno ukazao na to da li je ugrožena solventnost privrednog društva. Cilj ovog rada jeste da ispita značaj nivoa solventnosti i njegov uticaj na vrstu revizorskog mišljenja kod ove vrste privrednih društava. Uzorak ovog istraživanja obuhvatio je analizu 196 revizorskih mišljenja koja se odnose na 50 javnih društava u Republici Srbiji za period od 2010. do 2013. godine. Na taj način smo utvrdili najučestalija skretanja pažnje revizora prema nivou solventnosti uzorkovanih društava. Primetili smo da pozitivna mišljenja sa skretanjem pažnje čine čak polovinu pozitivnih revizorskih mišljenja, gde se kao najčešći uzrok izmenjenog teksta navodi ugroženost kontinuiteta poslovanja.

Ključne reči:
javna društva,
revizija finansijskih izveštaja,
revizorsko mišljenje,
solventnost,
načelo stalnosti poslovanja.