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THE NEW AUDITOR'S REPORT AND THE IMPACT OF AN EVENTUAL FINANCIAL CRISIS ON THE FINANCIAL AUDIT ACTIVITY IN EUROPE

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Abstract
Given the growing concerns in the current socio-economic context for obtaining more relevant and more „insuring" information on the quality of financial information provided by the financial statements of various companies, both practitioners and academics, but also regulators, are asking various questions on how external audits and audit reports are and should be looked at.
Unfortunately, during the financial crisis in 2017-2018 we faced a continuous degradation of the audit image, and by default of that of financial auditors. This is due to scandals and bankruptcies of companies and financial institutions, where auditors have contributed more or less. All these led to intensified efforts of audit professional and regulatory bodies for analysing the causes of these phenomena in order to identify and impose a number of measures aimed to restore the lack of credibility occurring increasingly stronger in the results of auditors' work.
Auditors and audit companies should not overlook the social importance of financial audits in recent years – a position obtained after an effort of hundreds of years - and eventually extend their responsibilities and seek for new methods or procedures compatible with current needs in order to support their work. Therefore, audit value must be continually tested against requirements of users and society. Accounting profession must build a solid case in favour of the benefits brought by audits to business, economy and society.
Audits must evolve and expand to add more value for users. Especially for listed companies and even more in times of crisis, audits must be more than an opinion on historical financial statements.
Over the last few decades audit quality has been investigated by many scholars, although it still hasn't been properly conceptualized and lacks one common definition. This may be explained by the constant shifting of audit theory and practice, and the complexity of the audit service. The objective of the paper is to investigate the existing definitions of audit quality, identify its main elements and provide a cristical observation on how the changes in the form and content of the auditor's report will affect the audit quality in an eventual sensitive socio-economic context.

Keywords: *financial audit, audit quality, financial crisis, credibility, perceptions, audit report*

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1. INTRODUCTION

In an increasingly integrated economy, *accounting information*, respectively its *credibility, relevance and integrity,* still are issues frequently studied by experts. In this context, we believe that research conducted so far have been performed from the standpoint of accountants as producers of information or from the perspective of its users, and *less from the standpoint of auditors*, who ensure the integrity and credibility of financial information against fraud.

The need for accurate and relevant information has always existed within all economic, social or any other activities, but its importance became evident in the last decade, with the financial scandals that have involved a number of large corporations.

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All these events have had a strong impact on the global economic market, outlining the possibility for some investors to fully lose confidence in investments made by companies, but also in their management.

In this context, *the role of financial auditors becomes very important*, namely to provide credibility to financial information in order to ensure a decision-making process based on accurate information, the functioning of cash-flows on capital markets and of economy as a whole.

In terms of the gap between users' perceptions and expectations on the audit, because during 2007-2008 the economic crisis deepened in Europe, also, since then, appeared a number of articles and studies that emphasize the *importance of the work of auditors, but also its relevance for the public interest*. These refer to the proposed models on the perception gap related to audit independence, for a greater awareness of auditors, regulators and the public of the risk of the existence of such gaps with adverse effects on the image of auditing profession (**Ţurlea & Mocanu (2010)**). Other studies deal with interdependence relationships and direct effects of auditors' independence on their performance (**Jaba & Robu (2011)**), the role of external audit in insuring credibility of audit reports (**Dobroţeanu et al. (2011a)**), degradation of perceptions and gaps between expectations and needs before and after the start of the financial crisis (**Dobroţeanu et al. (2011b)**), the link between restoration of public confidence and decrease of expectation gaps in terms of public interests (**Ardelean (2014)**).

The role and relevance of information provided by auditors to the public through audit reports is therefore a controversial topic, which in recent years has generated lots of discussions among experts and practitioners. *The risks to which users of information provided by auditors are exposed to have increased*, and also *diversified* considerably, due to the economic changes caused by the global crisis. Companies' attempts to embellish results and present a distorted image of financial statements also hinder auditors' activities for obtaining reasonable assurance. It is considered that an audit report containing a favourable opinion is in fact a business card that can facilitate new business opportunities for the audited company.

2. RESEARCH METHODOLOGY

Most of this article is dedicated to ***fundamental research***, containing a number of debates and standpoints about the financial crisis as a fundamental concept, respectively its impact on accounting theories and practices, and also standpoints about the contributions of the new auditor's report to the audit quality in case a new financial crisis, similar to the one in 2007, will burst in the near future. A future research will be reserved for the ***applied research***, where we will intend to put face to face the perceptions of the two groups about the impact of an eventual financial crisis on audit activities and profession in Europe, a crisis similar to the one we experienced starting with 2007.

By its nature, this article is part of the ***positivist research trend*** with extensive *interpretative approaches*, and with a number of *critical elements* and many *personal opinions*, which intertwine harmoniously and give the article a touch of originality and professionalism. In terms of generated information, this research focuses on a ***qualitative research*** (most investigated items are of qualitative nature).

The research follows a *transverse direction* through the used *observation, comparison* and *conceptual analysis* techniques. Thus, the qualitative research valued specialist literature by processing it with various *methods specific to socio-human* *sciences*, such as *document analysis*, *non-participating observation* and *comparison*. The non-participating approach is due to the research field and the current state of knowledge in the field of interest, although comparisons made and opinions and conclusions expressed show certain participating aspects of the research, respectively the relevance of transmitted information.

In our opinion, the dynamics of analysing scientific literature is extremely relevant in the analysis of audit evolution, and consequently for increasing complexity of tasks and responsibilities attached to financial auditors, the more that we talk about periods of financial crises. The sources used are mostly scientific articles published in specialist magazines in the field of financial audit.

3. THE IMPACT OF FINANCIAL CRISIS IN 2007 ON ACCOUNTING THEORIES AND PRACTICES

Currently, the socio-economic environment seems to be starting to go through a difficult situation, similar to global financial crisis that began since late 2007. In this respect, **A. Einstein** pointed out that: *„It is in crisis that invention, discovery and large strategies are born"*. This crisis implicitly „pulls" the alarm on production and procurement, but especially certification and use of financial information that have an important role in preventing, reducing or fighting such difficult situations.

The central concept of this article is the *financial crisis,* which concerns all stakeholders, calls for reconfiguration of economic philosophies and of the dominant logic and requires strategies for exiting the state of economic decay, tactics for controlling aggregation effects, dismantling of immobility and enhancement of stimuli.

The general global economic crisis and the financial scandals at large companies (Enron, WorldCom, Ahold, Parmalat, etc.) call again into question the ***quality and reliability of financial information***. Thus, the world's globalisation issues are reflected also on the evolution of accounting and auditing professions. Globalisation of world economy amid a global economic crisis creates new situations and doubts on everything related to the economy of each country.

These developments in the economic-social environment have often been improperly associated with the *accounting profession*, which is responsible for defending public interest by means of correctly informing external users, respectively guaranteeing credibility of data published by companies. For example, in recent years, ethical failures by certain members of the profession, which resulted in a lack of confidence in financial reporting, required significant changes in the rules of the profession (Sarbanes-Oxley Act in USA, Financial Security Law in France, etc.), as documented in their study by **Toma & Potdevin (2008: 33)**.

In our opinion, amongst the representatives of accounting profession, financial auditors are most exposed to virulent criticism coming from users of information within financial reporting. They are considered *„scapegoats",* as guarantors of quality and reliability of data disseminated by companies. Sometimes, it goes even further, considering that these professionals are *solely responsible for the failures faced by large companies* or groups of companies. Therefore, in our opinion, the reputation and responsibility of the financial auditor profession are directly influenced by the qualitative features of financial information, compliance with rules imposed by the accounting referential, and with principles of ethical and professional conduct.

In this context, as **Ion Mihăilescu**, the ex-president of the Chamber of Financial Auditors of Romania stated back in 2009, at the 2nd Congress of the

Financial Auditors in Romania, the role of the auditor increases: *„its value must acquire new levels by providing additional elements related to transparency of operations, the need of an increased vigilance towards complex financial products and the need to better understand both individual and systemic risks"* (**Ion Mihăilescu (2009)**). Professional accountants are required to make the necessary adjustments related to the way of reporting financial indicators, and for a more accurate understanding of situations by users. Thus, the importance of auditors will increase, because both creditors and investors, but also the large public, rely on their opinion of independent experts.

Thus, we, as auditors, should be concerned of identifying solutions for *regaining investors' confidence*, by identifying liquidities, because they do exist, but not at the right places. Auditors „see the financial reporting and activity of a company from two standpoints: information accuracy and going concern. Auditors should collect a sample of required, sufficient and appropriate evidence, so that in short time they can provide a relevant opinion resulted from the audit report. The report as a whole, and in particular the paragraph related to going concern, is one of the elements that support business environment and, corporate management" (**Ion Mihăilescu (2009)**).

The question is, *how do we proceed as auditors, how do we overcome another crisis and what did we learn out of the one in 2007?* In our opinion, the answer lies is how auditors, as accounting professionals, perceive the concept of *fair value* and perform the audit of the balance sheet, in how they identify and report *fraud*, respectively the *going concern audit*.

4. FINANCIAL AUDITORS' RESPONSIBILITIES TO THE CHALLENGES OF FINANCIAL CRISIS – CONVERGENCE BETWEEN THEORY AND PRACTICE

The global financial crisis that lasted for some time during 2007-2009 aroused acute concerns not only related to causes – which were discussed under all possible aspects – but especially to the real recovery and revival chances. In particular, the most appropriate mechanisms are sought for restoring trust in business and for creating a fair and predictable commercial and financial climate.

Inevitably, when looking for appropriate solutions hopes are related to the already learnt lessons and, thus, to the *potential offered by information obtained through financial audit*, which is recognised to have an increasingly prominent social role in ensuring business health. And it is not just about opinions on what is expected from auditors, but also about specific actions, which – as we saw – took the form of discussion papers for the preparation of measures considered necessary to be adopted.

Fact is that now financial audit is, once again, on the verge of a reform to better meet the challenges of the period we are going through. In our opinion, currently, audit is a global service, whose effects are felt throughout all economic fields and with cross-border impact. However, greater *public awareness of the objectives and scope of an audit would be necessary,* given that *public awareness deficiencies can cause deficiencies related to the public's expectations from auditors*.

There is a consensus that the *social role of auditors and audit profession* should action in the context of *protecting public interests*. Thus, the public must gain a proper understanding of the audit profession and not generalise it to believe that the auditor is a *factotum*, a god, an omniscient that can also do very long-time predictions.

The „Green Book" of audit, a discussion paper issued by the European Commission, even contains an attempt to charge auditors with a pretty unpleasant duty, namely to *make clear specifications on the period in which it is more likely for the audited company to resist*. This is very difficult, if not impossible. Not even rating agencies – which have mathematical techniques and statistical models – can do this. *What could an auditor do, who studies some situations related to the past?* He may issue an opinion, but cannot predict an exact period for the company's sustainability for more than one year, according to the going concern principle.

Given its impact on various stakeholders, *audit profession is very sensitive*. Thus, regulations and rules adopted domestically or internationally ought to be judiciously based on extensive research and market studies. It is necessary for the large public to gain a proper understanding of the audit profession in order to have reasonable expectations. On the other hand, the *profession is called to properly respond, to adapt as good as possible to the requirements of the current period*. Therefore, financial auditors are bound to be in a position to build confidence in both auditors and their professional bodies, first of all by the quality and accuracy of services provided by its members.

5. IMPROVING THE AUDIT QUALITY THROUGH THE NEW AUDITOR'S REPORT

The objective of an audit of financial statements is for the auditor to form an opinion on the financial statements based on having obtained sufficient appropriate audit evidence about whether the financial statements are free from material misstatement and to report in accordance with the auditor's findings.

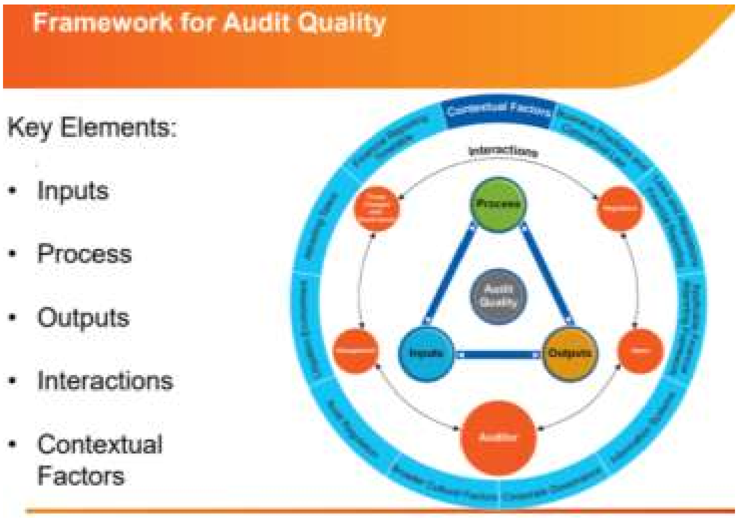
For an external audit to fulfill its objective the users of audited financial statements must have confidence that the auditor has worked to a suitable standard and that **"a quality audit"** has been performed. Audit Quality is a complex subject and there is no analysis of it that has achieved universal recognition. The **Framework** provides an insight into the ***key elements that create an environment for audit quality***.

Audit quality encompasses the key elements that create an environment which maximizes the likelihood that quality audits are performed on a consistent basis. A quality audit is likely to have been achieved by an engagement team that:

- Exhibited appropriate values, ethics and attitudes;
- Was sufficiently knowledgeable, skilled, and experienced and had sufficient time allocated to perform the audit work;
- Applied a rigorous audit process and quality control procedures that complied with law, regulation and applicable standards;
- Provided useful and timely reports; and
- Interacted appropriately with relevant stakeholders.

The responsibility for performing quality audits of financial statements rests with auditors. However, audit quality is best achieved in an environment where there is support from and appropriate interactions among participants in the financial reporting supply chain.

The Framework for Audit Quality provided by the International Federation of Accountants (IFAC) focuses on certain aspects:



(*Source*: https://www.ifac.org/system/files/uploads/IAASB/Framework-for-Audit-Quality-Outline.pdf)

Figure 1 – Framework for Audit Quality, IFAC

The topic of changing the auditor's report had been on the International Auditing and Assurance Standards Board (IAASB)'s agenda for some time, since 2006, when IAASB started with commissioning academic research about how users feel about the auditor report. As James Gunn, the Managing Director – Professional Standards stated on 13th of June, 2016, at the 6th Brazilian Conference on Accounting and Independent Auditing in Sao Paolo, Brazil, „they learned that the only thing in an auditor's report that was read is the audit opinion – a one-liner that tells you whether the financial statements are OK or not. Important? Yes. But we heard from a variety of stakeholders, in particular users, that more was needed. It was asked why auditors don't share more – about the audit, what they did, and why is it that none of that is made transparent – except the valued audit opinion? Well, they had a point. And all this even before the financial crisis. But that then heightened the demand for more communication from auditors" (**James Gunn (2016)**). In addition to this, to illustrate the reasons underlying the change in the auditor's report, we must also quote from the 2012 letter to IAASB from IBRACON: "*The global financial crisis and other related events have undermined investor confidence in corporate financial reporting and challenged the usefulness of the auditor's report and, more broadly, the relevance of the financial statement audit. We support the IAASB's initiative to explore options to enhance the quality, relevance and value of auditor reporting….[and] We believe the suggestions presented herein will improve the auditor's communication, making it more informative and significant to users… this will represent a significant advance.*"

In April 2017, the new International Auditing Standards (ISAs) issued by the IAASB dealt with: auditor reporting, changes to performance standards with respect to going concern, changes to address the audit of financial statement disclosures, and also with the reporting and other responsibilities relating to other information included in an entity's annual report.

The new and revised auditor reporting standards are designed to enhance auditor's reports for investors and other users of financial statements.

The auditor's report is the key deliverable communicating the results of the audit process. Investors and other financial statement users have asked for a more

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informative auditor's report—in particular for auditors to provide more relevant information to users. Research, public consultations, and stakeholder outreach, including global roundtables, indicate that enhanced auditor reporting is critical to influencing the perceived value of the financial statement audit.

The *intended benefits*, in our opinion, are the following:

- ✓ Enhanced communication between auditors and investors, as well as those charged with corporate governance
- ✓ Increased user confidence in audit reports and financial statements
- ✓ Increased transparency, audit quality, and enhanced information value
- ✓ Increased attention by management and financial statement preparers to disclosures referencing the auditor's report
- ✓ Renewed auditor focus on matters to be reported that could result in an increase in professional skepticism
- ✓ Enhanced financial reporting in the public interest

Adopted by more than 110 countries, the new auditor's report represents a step change in the information content of the report. It better describes *what an audit is* and *what an auditor does*, including an ***ability to provide transparency in the reporting of key audit matters (KAM)***.

The new auditor's report will be effective for all audits for periods ending on or after 15 December 2018, with earlier adoption permitted. The IAASB's effective date for these standards was for periods ending on or after 15 December 2016.

The following enhancements to the auditors'report have been made:

Tabel 1 – Enhancements made to the auditors'report

All entities Enhancements made to the new auditor's report, which are applicable for *all entities*:	**Listed entities** Beyond those enhancements noted for all entities, the following are enhancements applicable to *listed entities*:
• The format of the report has changed, with the opinion presented at the beginning of the report, followed by the basis for opinion. • The new auditor's report contains an affirmative statement of independence and fulfillment of relevant ethical responsibilities. • A description of management's and auditor's responsibilities relating to going concern is required, and a separate dedicated section related to material uncertainty is required when a material uncertainty exists. • The new auditor's report discloses identification of those charged with governance (TCWG) within the management's responsibilities section. • There is an expanded description of auditor's responsibilities, including key features of an audit. • For all entities with "other information," such as an annual report, disclosure of other information that the auditor is required to read but which the auditor has not yet received at the date of the auditor's report is required.	• Disclosure of the name of the engagement partner is required. • There is a new section in the auditor reporting standard addressing KAM, which are those matters that were considered to be of most significance in the audit of the current period. Disclosure of KAM will be optional under the Canadian standard unless required by law or regulation.

(*Source*: Ernst & Young – Adoption of New Auditors Reports (2017), https://www.ey.com/Publication/vwLUAssets/EY-adoption-of-new-auditors-reports-july-2017/%24File/EY-adoption-of-new-auditors-reports-july-2017.pdf)

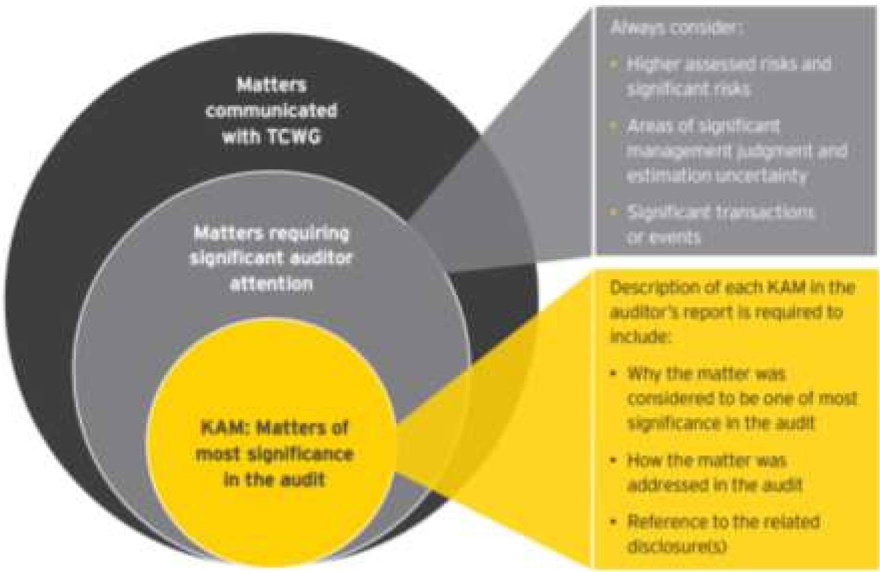
Therefore, a key feature of the new audit report is the fact that ***the audit opinion is now presented first***, basically because the users raised their voice to the IAASB, stating the fact that they first want to know the conclusions, because this is what they are actually interested in. Then, thrrough key audit matters, they want to be told how auditors got to that conclusion.

In essence, not much has actually changed on the ***going concern assurance***. We can observe, however, that there is now clearer signaling when there is a going concern issue. And in the specific ISA 570 on Going Concern, there is a clearer imperative for auditors to be satisfied with management's disclosure of their judgements around going concern, in particular in "close call" situations.

Also, a new section has been created in order to clearly explain the ***auditor's work effort with regards to other information*** and exactly what information the auditor has looked at.

And finally, among others, there was also a permanent new requirement to ***name the engagement partner***, which many jurisdictions globally were already doing – thus, further modernizing the international reporting model.

But, probably the most significant change that introduces a new level of transparency into the audit process in the new standards is the ***introduction of KAM***. KAM are defined as: "Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. KAM are selected from matters communicated with those charged with governance."



(*Source*: Ernst & Young – Adoption of New Auditors Reports (2017), https://www.ey.com/Publication/vwLUAssets/EY-adoption-of-new-auditors-reports-july-2017/%24File/EY-adoption-of-new-auditors-reports-july-2017.pdf)

Figure 2 – The Introduction of KAMs in the New Audit Report

To explain KAM very simply: auditors now describe in their public reports what they saw as the matters of most significance in the audit, and how those matters were addressed in the audit.

The framework in ISA 701 provides auditors with a decision-making process to determine KAM, and it is about judgement, about what is relevant to communicate. The process is intuitive: start with essentially what already is being discussed with the audit committees. That focuses the lens on the salient matters. Then, further focus on matters requiring significant auditor attention – it could be areas of higher risk, or areas of significant auditor judgment. And then, think about what is really unique and relevant in this particular audit for this particular entity – that is, what is the matters of most significance.

The new standard is required for listed entity audits, since the public market investor community has been the most vocal about it. The final reporting standards, as adopted, do not contain a KAM reporting requirement at this time. However, they do allow for law or regulation to require reporting of KAM and for the auditor to decide to do so.

To sum it up, the basics of communicating KAM are, essentially, the following:

i. *why the auditor judged a matter to be of most significance in the audit;*
ii. *how that matter was addressed in the audit;* and
iii. *reference to any related financial statement disclosures.*

This being said, we can state the fact that ***auditors are thinking now in terms of the lens of the reader, the investors, the users***, this being exactly the reason former IFAC president Warren Allen called the new Auditor Report "a step change."

In conclusion, significant efforts will be required to implement the enhanced auditor's reporting standards. Management, those charged with the governance, and the auditors should align their goal of improving communications so as to ensure smooth implementation in 2018 calendar-year audits. Effective implementation is critical to the success of the new and revised Auditor Reporting standards. Everyone – investors, regulators, audit oversight bodies, audit committees and others – has an important role in effecting the change society wants to see in auditor reporting.

6. FINAL CONCLUSIONS AND PERSONAL CONTRIBUTIONS

Our scientific approach started from a question on how external audits and audit reports are and should be regarded in view of the current sensitive socio-economic context. Although the original question seemed simple at first sight, during our research we noted the magnitude of the context, factors, differences and opinions that influence but also result from this activity. Therefore, our research took into consideration the more intense concerns in the current economic context for obtaining relevant and „insuring" information on the quality of financial-accounting information provided by various companies' financial statements.

In a world where the concept of globalization tends to become obsolete, where dynamism and complexity of financial operations reached levels that were difficult to anticipate, facing more often in recent years the effects of economic decisions influenced by a number of professional and ethical factors, financial audit, by means of the *audit report*, can and should become again one of the main pillars that underspin decision-making.

In our opinion, financial audit progressed and improved in line with the economic development, in response to the challenges of the society. It progressed historically, being present in some form in all periods in terms of concept and especially in terms of goals. Therefore, we believe that auditors and audit companies should not overlook the social importance of financial audit in current days, its position obtained after hundreds of years of efforts and eventually to extend its responsibilities, to seek new methods or procedures compatible with current needs that would support their work.

The idea of this article is that the *value of an audit should be tested permanently against the requirements of users and society*. *Accounting profession must build a solid case for the benefits that audits bring to business, economy and society*. Audit market is very sensitive, thus accurate perception of stakeholders of auditors' activity is essential.

The debate focused mainly on the fact that the *crisis in 2007 was generated not only by corporate blunders, but also by mistakes of governments and their budgetary policies*. In this context, we believe that *statutory audit could play a more active role in consolidating the global economic environment if it would be more involved in the audit of public institutions, including financial and budgetary policies*.

Based on the performed analysis, we noted that indeed the *financial crisis has had an impact on the activity of financial auditors in Europe.* Thus, based on the research performed, we concluded that *audit evolved and expanded since then, in order to add more value for users*, and must continue to do so. Especially for listed companies and more than ever in times of crisis, audit must be more than an opinion on the historical financial statements. Auditors should be continually involved in aspects such as: *corporate governance effectiveness*, *assumptions underlying the business model of an organisation and its risk management*.

In our opinion, among all the presented potential benefits of a new style reporting, the ones related to the following must be emphasized, especially if we believe that another financial crisis will follow:

- ✓ *direct stimulation of even more robust interactions and communications between auditor and entity*;
- ✓ *improve audit quality* – because if a matter is going to be discussed in the auditor's report, then greater focus by management especially on their own disclosures, and also even greater attention and scepticism by the auditor, might result;
- ✓ *better understanding of the (probably) least understood service*, from a user perspective (foscusing on what the auditors'responsibilities are, but not boilerplating, rather, communicating what really auditors have been focusing on).

(*Source*: own projection)

Figure 3 – Continuing improvement of the audit quality in order to meet the public interest

As a final conclusion – in our opinion – it is necessary for both the profession and the society as a whole to reach a *reasonable balance between the degree of* *responsibility and accountability that an auditor should assume* related to the fair presentation of financial statements and audit costs for the society.

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