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ANALYSIS OF AUDITOR'S REPORTS AND BANKRUPTCY RISK IN BANKING SECTOR IN THE REPUBLIC OF SERBIA

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Abstract

This paper aims to point out the significance of external audit and auditor's reports. The stability of banks and its operations are vital not only for efficient financial system functioning, but also for overall industry. The banking sector, both in developed and undeveloped countries, experienced financial crisis in the last few years. Considering these circumstances and the fact that demands of financial statements users grow in complexity, their control is essential. We provide the empirical evidence on the banking sector auditor's reports in the Republic of Serbia, with particular reference to auditor's opinions and audit agencies that had conducted banks audits. The review of the audit legislation and professional standards will be presented, as well as the notion of bankruptcy risk and its relevance for banking sector. Our research results indicate that special attention should be paid to banks which auditor's report had some explanatory paragraphs or even qualification. In conclusion we highlight the red flags that may damage banks operations and emphasize the importance of keeping the high level of auditor's independence with the intention to provide confidence to stakeholders who form their decisions based on their reports.

Keywords: audit, banks, financial statements, insolvency, risk

JEL Classification: M42

Introduction

Considering that auditor's opinion provides credibility to financial statements and enhances the confidence degree of stakeholders in the financial statements and business operations of an entity, all financial statements users are particularly interested in auditor's report. Since banks are the most important contributor to the financial system, their operations and stability represent an issue of general public concern. Therefore, in this paper we are going to show our research findings that dealt with auditor's reports in banking sector in the Republic of Serbia.

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Moreover, there are threats, like frauds and financial manipulations, which may seriously harm bank's businesses and consequently the national and global industry. Systematic risk could be magnified by bankruptcy of main financial institutions. Thus, these risks make audit more responsible and necessary in communication between management of the bank and their stakeholders. Therefore, we define our hypothesis: Although auditor's reports should not provide the analysis of financial health of banks, their certain type could indicate deterioration of financial stability.

The aim of our study is to examine auditors' reports in Serbian banking sector in the period of 2007-2011 and to present the market shares of audit agencies which audited banks in the aforementioned period. In the first part of this paper, we will review the importance of auditing process and auditor's reports issuing in the final. We will also familiarize reader with all categories of auditor's reports and stress out the importance of healthy banking system, which has been especially endangered in global financial crisis period. In the second part of the paper, we are going to present the key Serbian banking sector characteristics and changes that happened in the last year. Finally, we will show research methodology and the findings of our research, i.e. review of auditor's reports distribution in banking sector in Serbia, as well as review of auditors' agencies firms in the period of examined five years.

1. Financial Statements Audit

In times of recession, when many large and stable companies face problems in their businesses and some even go bankrupt, investor's eyes are focused on independent auditors and their reports on company's operations. The markets are tired of the Enron and WorldCom-type failures and want assurance that those kinds of problems are not happening in companies in which they invest (Rittenberg et al., 2008). As society becomes more complex, decision makers are more likely to receive unreliable information (Arens et al., 2008).

With the aim to conceal financial frauds, managers often use fraudulent bookkeeping to present financial position and result of operations as wanted, although for example the company is operating at a loss. Therefore, auditor's opinion is especially important to all users of financial statements, particularly in decision making process, since it provides a higher level of assurance in information presented in company's financial statements. Consequently, external auditors have to keep high level of independence in order to provide confidence to users who rely on their reports. The expertise of auditors is highly valued and auditing is considered as vital in imposing discipline upon management presentation of financial information.

The possible threats that may affect the banks stability are frauds and financial manipulations. According to Rittenberg, Schwieger and Johnstone (2008), a study by the Association of Certified Fraud Examiners estimated that companies have historically lost up to 6% of revenue as a result of fraud. Those numbers do not include the losses that investors incurred on major financial reporting frauds such as Enron (estimated to be near \$90 Billion) or WorldCom.

Considering that auditing is the process of collection and evaluation of evidences regarding information presented in financial statements, it should be done by competent and

independent person. Auditors who are reporting on company's financial statements are often called independent auditors. Even though such auditors are paid fees by the company, they are normally sufficiently independent to conduct audits that can be relied by users (Arens et al., 2008).

The audit report represents the final step in the audit process. Summarizing evidence collected during the audit process and giving a conclusion about client's financial reports represent the overall goal of an audit engagement. A financial statements audit is conducted with the aim to determine whether the financial statements of an entity are fairly stated in accordance with specified criteria (International Accounting Standards – IAS, International Financial Reporting Standards - IFRS, Generally Accepted Accounting Principles - GAAP, etc.) and whether they contain material errors or other misstatements. International Standard on Auditing that directly regulates auditor's report is ISA 700 *Forming an Opinion and Reporting on Financial Statements*. ISA 700 provides guidance on the independent auditor's report issued as a result of an audit of a complete set of general purpose financial statements prepared in accordance with an applicable financial reporting framework.

Since nowadays businesses increase in complexity, auditors have to focus not only on accounting transactions and risk of misstatements, but also on understanding of operating controls, entity and its regulatory, as well as operating environment. The auditors also need to consider client's business strategies in order to identify operating risks that may have impact on going concern evaluation.

Even though the auditor's report contains several distinct parts, the most interesting and significant part for users without any doubt is final, opinion paragraph. In this paragraph the auditor states its conclusion based on the results of the conducted audit process. According to Rittenberg, Schwieger and Johnstone (2008) there are five categories of audit reports, as following:

- Standard unqualified report,
- Unqualified report with explanatory paragraph,
- Qualified report,
- Adverse report, and
- Disclaimer of opinion report.

Standard unqualified report represents the most common report in practice. It is also called a *clean opinion* since there had been no circumstances that required modification of the auditor's opinion. The results of our conducted research, which reviewed the auditor's reports in Serbian banking sector, show that the largest share in distribution of issued reports took unqualified reports or unqualified reports with explanatory paragraph. Standard report indicates that all criteria of a complete audit have been met with satisfactory results and the auditor believes the financial statements are fairly stated in conformity with accounting principles.

Auditors may add explanatory paragraph (explanatory language) to their auditor's report when expressing an unqualified opinion. Adding the explanatory language is not regarded as a qualification; rather the language merely draws attention to a significant situation (Whittington and Pany, 2008). This paragraph is commonly used in auditor's report and it needs to be stated after the opinion paragraph.

Issuing a qualified report means that auditor has reservation or uncertainty with reference to fair presentation in some parts of the client's financial statements. Unlike explanatory paragraph, all qualified reports have a separate explanatory part of the report stated before the opinion paragraph in which are disclosed reasons for qualification. The exception must be sufficiently significant to warrant mentioning in the auditor's report, but it must not be so significant as to necessitate a disclaimer of opinion or an adverse opinion (Whittington and Pany, 2008).

An adverse opinion is uncommon and rarely used due the reason most clients follow the accounting principles. The auditor expresses adverse opinion when he/she believes that the overall financial statements are materially misstated and do not present fairly financial position, results of operations and cash flows of the client in compliance with specified accounting standards. Moreover, auditor should state in a separate paragraph the reasons for this kind of opinion and significant effects on financial statements, if the effects can be determined.

The most undesirable opinion is a disclaimer of opinion, which actually means no opinion. The substantial scope limitations or uncertainties that preclude auditor's compliance with accounting standards will prevent auditor from expressing an opinion on the financial statements as whole. In this case the auditor is saying he/she has no opinion, mentioning the reasons for disclaimer.

2. Audit Legislation Review in the Republic of Serbia

Accounting practice in Serbia is based on the Law on Accounting and Auditing (Official Gazette of Republic of Serbia, 2006) and other regulations. According to the Law on Accounting and Auditing, auditing of annual financial statements is mandatory for large and medium-sized legal entities, as well as for small legal entities which issue securities public offer, or whose securities are being traded on the organized securities market. In accordance with aforementioned Law, banks are audit obligors. Article 4 of the Law on Accounting and Auditing defines authorized auditor as "an independent professional person conducting audit services and being responsible for correct auditing, for making audit report and for expressing audit opinion in compliance with the International Standards on Auditing and this Law".

In Serbia, the financial statements have to be prepared in accordance with specified criteria of IAS/IFRS set by IASB. International Auditing and Assurance Standards Board (IAASB) set the International Standards on Auditing (ISA) that regulate the process of audit. Moreover, the auditors must act in accordance with the Code of Ethics for Professional Accountants issued by the International Federation of Accountants (IFAC), as well as to comply with local and national standards.

3. Bankruptcy Default Risk and Its Impact on Banking Sector

The banking sector had experienced numerous difficulties during the financial crisis period. In the post-crisis period, banks are paying more attention particularly on risk management and restoration of customer confidence. With the aim to restore not only customers

confidence, but also the confidence of all stakeholders, banks management need to provide relevant and true information presented in financial statements.

In the last few decades, there were a lot of mergers and acquisitions in banking sector, which had a strong influence on global banking system and complexity of new banking services developed to satisfy customer's needs. At present, all the markets in the developed and developing countries are going through a difficult period, because of the financial and bank crisis that has affected systems across the board, and that is widely expected to lead to an economic depression (Jawadi, 2010). Barth and Landsman (2010) stated that banks were at the centre of the financial crisis, which resulted in near systemic collapse of the banking sector.

There are few researches regarding bankruptcy prediction models creation that used number of auditor remarks of one company at certain point of time as explanatory variable of company's health. It has been concluded that previously mentioned indicator presents very powerful predictor of failure (Dakovic et al., 2010). Likewise, several researches regarding financial crisis and bankruptcy prediction in banking sector explain that distressed banks usually carried out an aggressive strategy of deposit taking that resulted both in higher interest income and expenses (Lopez et al., 2010). Bank's loan portfolio of poor quality resulted in creation of more provisions for defaults and resulted in increase of losses a short time before the bankruptcy. In order to overcome financial crisis some authors suggest that banks should implement methods which effectiveness have been proved already. The Bank of Amsterdam in 1763 experienced crisis similar to current one and overcame it by increasing significantly its liquidity through broadening the range of acceptable collateral for its repo transactions (Quinn and Roberds, 2012).

Increasing number of bankruptcy procedures in financial institutions has been apparently the consequence of world economic crisis, which started at the beginning of 2008. The mortgage loans obviously caused such enormous number of bankruptcies. Until 2006, real estate market in the United States of America (USA) was in progress and in that moment no one could predict that property prices would fall rapidly. From 2000 to 2007, the average value of properties sold increased by 56%. Easy access to the large sources of capital that had been invested in this sector made investors and individuals feel secure. People felt so protected that they started to purchase properties using mortgage loans, which they could not pay back.

In the moment of prosperity, if minor number of clients could not pay back their loans, that would not affect bank's businesses significantly, which resulted in banks relaxed conditions for approving loans. In order to keep bank's capital available at any time and bearing in mind that mortgage loans are long-term loans, banks sold their receivables to broker houses, making the procedure of debt collection accelerated. Moreover, brokers go one-step further, merge several mortgage loans and create new security named MBA (Mortgage Backed Securities). Certainly, in order to trade this type of securities brokers had to get acceptable credit rating from one of three credit rating agencies: Moody's, Standard&Poor's and FinCredit. In this way, further selling of this type of securities was enabled to other companies and financial institutions. As real estate's prices increased rapidly, the values of these securities were artificially bubbled. Thus, financial institutions showed unreal values in their financial statements and continue to borrow progressively. However, when people began to pay back their payments less frequently, first problems for financial institutions

occurred. At the end of 2007, almost 16% of overall mortgage loans were entirely uncollectable (Pozen, 2010).

The assets showed in financial statements became assets that were impossible to sell (Toxic Assets), while loans repayments were also deteriorated. Average value of assets sold dropped approximately by 20%. By estimation, credit rating agencies lower credit rating of mortgage securities by 1.900 million dollars. This leads to the question what is the function of individual bankruptcy in financial crisis. The largest number of opened bankruptcy cases was in accordance to Chapter 7 (The Bankruptcy Code) and this was not an option randomly made by people (United States Courts, 2005). Moreover, in accordance to Chapter 7, bank or financial institution that collects mortgage payments from an individual, has no legal right to require debt in total amount, but has right to sell mortgaged property and pay back its payment. Bankruptcy debtor according to Chapter 11 (Reorganization under the Bankruptcy Code) and 13 (Individual Debt Adjustment) has no this kind of option.

Nevertheless, aforementioned would not have made problems if prices of properties had not fallen quickly and financial institutions sometimes could not collect even part of overdue loans. This means that individual has more advantages to open bankruptcy procedure than to pay back his/hers obligation. President of the USA Barack Obama has often reminded in his speeches that people has a moral obligation to pay back their payments to financial institutions. However, only setting up the rigid regulations regarding bankruptcy procedures have reduced the number of bankruptcies.

4. Banking Sector in the Republic of Serbia

In Serbia, banks play the major role in financial system, considering the fact that they take the largest share in the financial system structure (table no. 1). Banking sector participate with 92.4% in balance sheet total of the National Bank of Serbia - supervised parts of the financial sector, which makes it the main contributor to its stability. Therefore, it is greatly important to develop and retain the fair, objective and transparent financial reporting system, as well as to focus on potential risks that may affect bank's operations.

Table no. 1: The Structure of Financial System in the Republic of Serbia

	December 31, 2010			December 31, 2011		
	Number	Balance Sheet Total	Share (%)	Number	Balance Sheet Total	Share (%)
Banking sector	33	2,533.5	91.8	33	2,649.9	92.4
Financial leasing providers	17	98.8	3.6	17	80.2	2.8
Insurance companies	26	117.1	4.2	28	125.7	4.4
Voluntary pension funds	8	9.8	0.4	9	12.5	0.4
Total	84	2,759.2	100.0	87	2,868.3	100.0

Source: The National Bank of Serbia

Nevertheless, Serbia is still in the process of transition and there are many difficulties that banks are faced with. Financial system is globally exposed to various risks and even though Serbia granted member state candidate status for EU membership, banks are still exposed to the country risk. However, unlike other developed countries, financial system in Serbia is more affected by political situation. Moreover, government has been changed this year, which made situation in country more volatile. Just ten years ago, in 2002, 50 banks operated in Serbia. Currently, the number of banks has been reduced to 33 and there is tendency of banks merging and acquisitions in the future. There are also speculations regarding capital increase of some state-owned banks in order to keep major domestic ownership. According to Annual Report on Activities and Results published by the National Bank of Serbia (2011) at the end of 2011, in the Serbian banking sector 21 banks were majority foreign-owned, private capital dominated in 4 banks, while 8 banks were majority-owned by Serbia.

The process of bank audit is regulated by the following laws and by-laws:

- Law on Accounting and Auditing ("Official Gazette of the Republic of Serbia", No. 46/06, 111/09 and 99/11),
- Law on Banks ("Official Gazette of the Republic of Serbia", No. 107/2005), and
- Decision on External Audit of Banks ("Official Gazette of the Republic of Serbia", No. 41/2007 and 59/2008).

The National Bank of Serbia sets the list of external auditors that may conduct the audit of bank's financial statements. Auditors have to satisfy the prescribed criteria in order to be included in the list. The following audit firms may engage in audit based on the National Bank of Serbia's decision on the listing (The National Bank of Serbia, 2011):

- Deloitte, d.o.o
- Ernst & Young Beograd, d.o.o
- KPMG, d.o.o., Beograd
- MOORE STEPHENS REVIZIJA I RACUNOVODSTVO, d.o.o.
- PricewaterhouseCoopers, d.o.o., Beograd
- BDO d.o.o., Beograd

5. Research findings

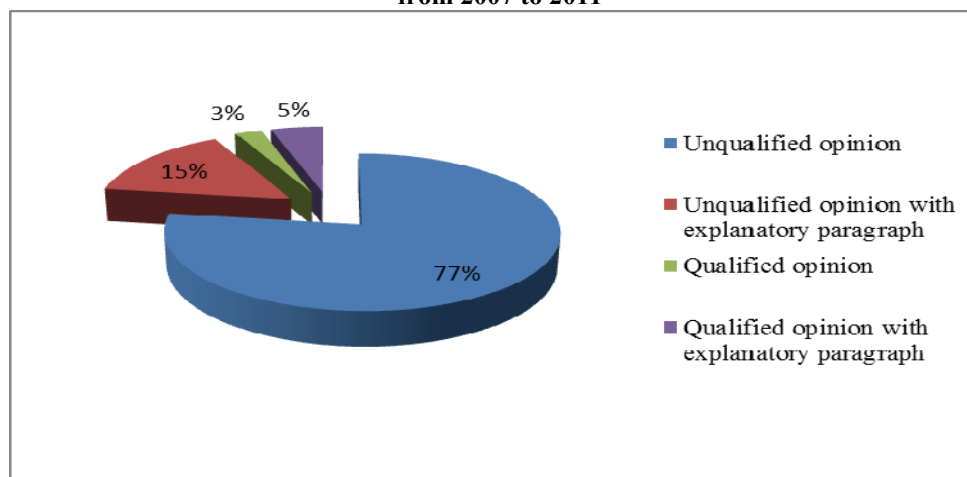
Considering that banking sector dominates in financial system of Serbia, with 92.4% share in balance sheet total in 2011, we decided to make a review of issued auditor's reports in our paper. Our research included 33 banks that operate in Serbia, which makes the total population. For the purpose of this paper, we used secondary data collection. All data were collected from banks and Serbian Business Registers Agency's web sites as well.

The performed reviews of auditor's reports refer to the period of five years, from 2007-2011. We analyzed the structure of auditor firms' engagements in the aforementioned period as well. Our analysis included 163 auditor's reports. Notice that report of Agrobanka is not available for 2011, because it has not been publicly presented even though it was obligatory, as well as report of Moskovska bank for 2007 due the reason it started to operate one year later, in 2008.

Out of 163 reports, 93% represent unqualified reports, while qualified reports share 7%. There were none of adverse or disclaimer of opinion. In order to make more detailed

structure of auditor's reports issued, we divided unqualified reports in two categories: standard unqualified report and unqualified report with explanatory paragraph. We noticed that some qualified reports contain explanatory paragraph as well. Therefore, we decided to categorize those reports as separate category - qualified opinion with explanatory paragraph. The modified and more detailed structure of issued auditor's reports is given below (figure no. 1).

Figure no. 1: Auditor's Reports Review in Banking Sector in the Republic of Serbia from 2007 to 2011



Source: Authors' data

Unqualified opinions dominate in the structure of auditor's report, which has been expected considering the fact that banks should present the most transparent financial statements reports. The attention should be paid on qualified opinions (8%), especially on qualified opinion with explanatory paragraph (5%). These explanatory paragraphs may be considered as red flags that indicate some problems in bank's operations, which potentially may lead to the serious business difficulties or even bankruptcy.

Banks in Serbia rarely invest in financial instruments in contrast to banking system in USA. This means that there is significant connection between balance sheets of banks and other companies and risks of possessing financial instruments. This is not the case in banking system in Serbia, which means that the bankruptcy of one bank will not have significant domino effect on business of other banks in this system, opposing to the financial markets of USA. We also point out that different banking model can protect the bank from effects of crisis, to some level, as it has been noticed in Canada, South Africa and Europe where traditional models and cooperative banks have been less affected by the crisis (Baicu and State, 2012).

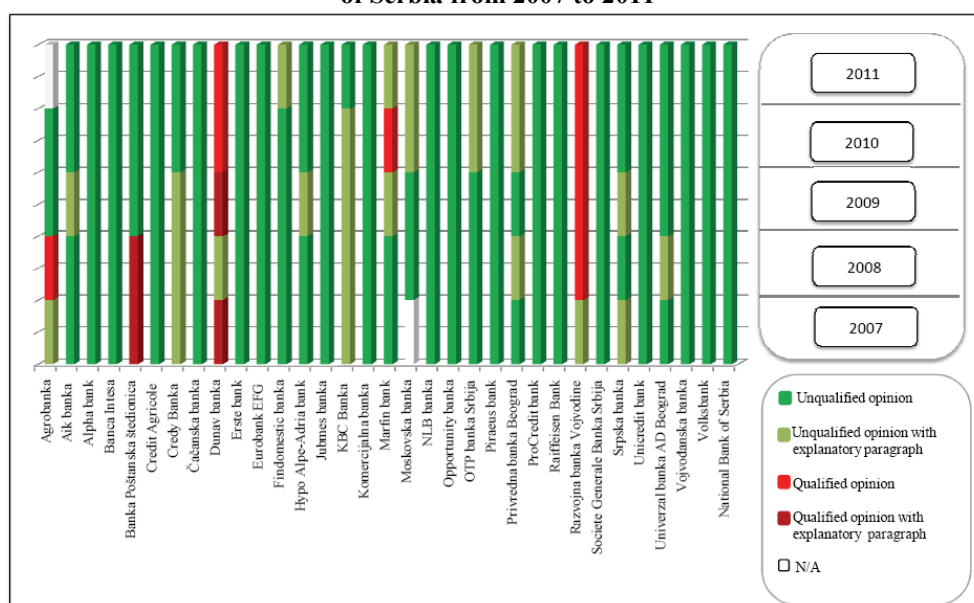
Frauds happen not only in developed countries, but in undeveloped as well. Unfortunately, in recent period we have witnessed one of bank bankruptcy in Serbia. The case of Agrobanka has been an issue frequently discussed in previous year. This bank disclosed almost RSD 29.5 billion loss (nearly EUR 280 million) in 2011. In 2010, Agrobanka disclosed RSD 1.2 billion profit (EUR 11 million). Only one year later occurred that uncollectible loans exceeded RSD 29 billion (EUR 280 million), which indicates that

financial statements have not presented fairly the financial position and results of operations in 2011. Despite these irregularities, Agrobanka got standard unqualified report in 2010, without any explanatory paragraphs and concerns noticed by the auditor. The bank got qualified report only in 2008.

On the other side, Razvojna banka Vojvodine got qualified report with explanatory paragraph for each year in the period from 2008 - 2011, with exception of 2007 when it got unqualified report with explanatory paragraph. Some of the main reasons for qualification were issues regarding capital adequacy and uncollectible loans. Therefore, the National Bank of Serbia continuously supervises its operations since qualified report points out red flag for all stakeholders. Policy measures such as enhancing transparency, resolving conflicts of interest and betterment of the existing regulatory and supervisory frameworks should be developed and introduced (Kavkler & Mejra, 2010).

The figure no. 2, given below, shows review of issued auditor's reports for all 33 banks in the analyzed period of five years. Among 33 banks, 18 of them being reported as unqualified opinion without any explanatory paragraph for each of five years (dark green colored bars). The attention shall be especially paid on qualified opinion (red colored bars), for the reason that it may indicate some significant difficulties in their future operations.

Figure no. 2: Distribution of Auditor's Reports in Banking Sector in Republic of Serbia from 2007 to 2011

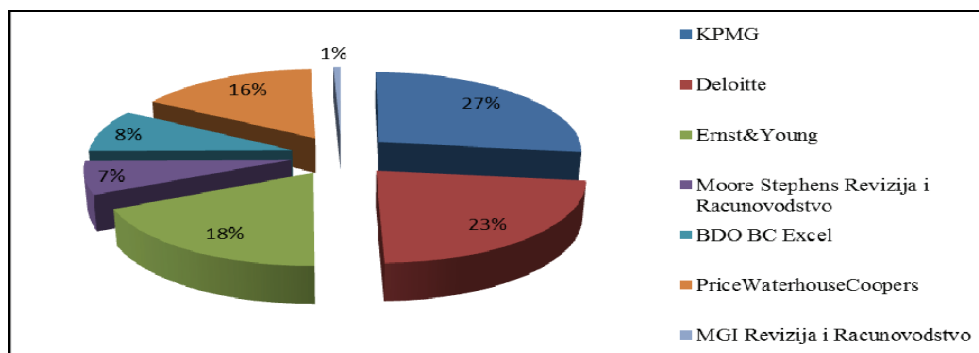


Source: Authors' data

The Big Four (PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young and KPMG) takes the largest share in banks audit engagements in Serbia, which is expected considering the fact that the Law on Accounting and Auditing and Law on Banks set criteria that have to be satisfied by the audit firm in order to conduct auditing. KPMG holds the largest slice of the market-share pie (figure no. 3). Significant share have also the other members of Big Four. Research conducted in USA by Public Accounting Report (2010) in

banking industry gave the same order of Big Four, as well as our research shown below in figure no. 3 (KPMG, 2010).

**Figure no. 3: Banks Audit Client Market Share in the Republic of Serbia
from 2007 - 2011**



Source: Authors' Data

Conclusions

As a dominate sector in the structure of financial system in Serbia, the banks and their operations are especially important for the country and overall industry. The recent financial crisis resulted in the collapse of many financial institutions worldwide and caused the loss of stakeholder's confidence in banks. The public wants assurance regarding the stability of banks and their operations, which makes banks auditing more responsible.

At the end of last year, the bankruptcy of one bank in our country occurred, which got unqualified auditor's report in the previous year, even though it struggled with severe problems. In circumstances like this one, the public firstly starts analyzing auditor's reports in very last few years. As the bank's operations grow in complexity, the public expectations on auditing become more and more demanding.

The results of our research show that the largest percentage of banks got unqualified auditor's opinion and this tendency is expected to be continued. However, the attention of stakeholders needs to be paid on qualified reports, as well as on all explanatory paragraphs, regardless the given opinion. The issues noted in explanatory paragraphs may indicate or even predict the problems that can affect operations of banks harmfully in the future, which makes our hypothesis confirmed.

Considering political transformations in Serbia, national and global economic environment, there should be expected changes in banking sector, as well. Especially after the last year changes in this sector, the National Bank of Serbia recognized the necessity of more strict banks control and this trend should be kept in the future. Only transparent flow of information between management and auditor will contribute to harmonization of accounting policies, standards and overall auditing process. Moreover, it will prevent and reduce severe problems and possible bankruptcy risks, as well as trust providing in whole banking system, particularly in post-recession period.

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